DEPARTMENT OF THE INTERIOR AND RELATED AGENCIES APPROPRIATIONS FOR 1987

HEARING

BEFORE A

SUBCOMMITTEE OF THE

COMMITTEE ON APPROPRIATIONS

HOUSE OF REPRESENTATIVES

NINETY-NINTH CONGRESS

SECOND SESSION

SUBCOMMITTEE ON THE DEPARTMENT OF THE INTERIOR AND RELATED AGENCIES

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PART 12

ROYALTY MANAGEMENT

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DEPARTMENT OF THE INTERIOR AND RELATED AGENCIES APPROPRIATIONS FOR 1987

THURSDAY, SEPTEMBER 25, 1986.

DEPARTMENT OF THE INTERIOR

ROYALTY MANAGEMENT

WITNESSES

DONALD PAUL HODEL, SECRETARY OF THE INTERIOR

WILLIAM D. BETTENBERG, DIRECTOR, U.S MINERALS MANAGEMENT SERVICE

GERALD R. RISO, ASSISTANT SECRETARY—POLICY, BUDGET AND ADMINISTRATION

ANTHONY L. ITTEILAG, DIRECTOR OF BUDGET

INTRODUCTORY REMARKS

Mr. YATES. Ms. Reporter, show the hearing as coming to order.

We are pleased this morning to have as our witness before our committee the Honorable Donald Hodel, who is the Secretary of the Interior.

I don't know whether you have a statement. I don't suppose you have one because you don't know why you are here, if I can understand it properly.

Secretary HODEL. My understanding, Mr. Chairman, is among the things you would like to talk about today are some of the things we talked about when I first appeared before you as Secretary, which included the Minerals Management Service and several other things.

When you and I talked about this hearing, you mentioned you thought at least that subject would be covered here today.

Mr. YATES. That subject is going to be covered. After your testimony, we looked forward to your coming back, but you know, you lulled us with what you are going to do to such an extent, we didn't call you back.

In measure, this is the call back.

Secretary HODEL. I understand.

MINERALS MANAGEMENT SERVICE

Mr. YATES. I must tell you in utter candor and frankness, I am just appalled by what is happening in the Minerals Management Service, not just by what is happening, but by what is not happening.

I can't believe that you know what is going on and what isn't going on there because you are a pretty good administrator. I will tell you in all candor again, that after I analyzed all the material that I have, I came to the conclusion that that Minerals Management Service ought to be transferred to IRS. I am serious.

IRS is a collection agency and the Minerals Management Service is trying to be a collection agency and is not succeeding very well. It is trying to be a collection agency and a disbursement agency at the same time, it has a great many other duties to perform.

I don't know which occupies most of its time, but I suspect that most of its time is taken up in preparing for leasing of the Outer Continental Shelf and very little time is taken up with collection.

I reviewed the hearings going all the way back to the formation of MMS and I reviewed what Senator McClure and Senator Melcher said at the time that this came up in 1982. It was so bad then, when Secretary Watt was the Secretary, and I think you were Under Secretary at the time, that a Linowes Commission was appointed.

You know about that as well as I. When the Linowes Commission findings were made public, and the legislation creating MMS was before the Congress, both Senator McClure and Senator Melcher made statements that I think are so applicable today.

Let me just read you what they said at the time.

December 6, 1982. In bringing the legislation to the floor of the Senate, Senator McClure said this, "This legislation is necessary because our present royalty management and collection system is both archaic and ineffective."

I think that is true today, even though we have spent in excess, I think, of $50 million on the VAX system which is still being used because the so-called new system is not ready yet and we have a letter from Martin Marietta, your contractor, and I am going to put this letter in the record, dated December 23, 1986, addressed to our investigative staff.

MARTIN MARIETTA DATA SYSTEMS

The letter says, "Martin Marietta Data Systems is unable to provide a date for completion of the Systems Test portion of the AFS conversion." That is your conversion. They can't give you a completion date.

[The information follows:]

Martin Marietta Data Systems,
Field Services Division,
Englewood, CO, September 23, 1986.

Mr. James J. O'Kane,
Surveys and Investigations Staff, Appropriations Committee, House of Representatives, Washington, DC.

Dear Mr. O'Kane: Following is the additional information you requested regarding the AFS conversion program:

Martin Marietta Data Systems is unable to provide a date for completion of the Systems Test portion of the AFS Conversion. The reasons are:

A Joint Test Plan was proposed to Minerals Management Services in late August; to date, we have no resolution.

The poor condition of the Test Data environments supplied by Minerals Management Services makes it difficult to accurately schedule.

Respectfully yours,

Gary P. Mann, *Vice President.*

Mr. **Yates.** Mr. Bettenberg, when he was before us, kept telling us, well, it will be completed by that day. Then we got a letter, a quarterly report, saying it slipped and we get another date.

When that date is coming along, we get a letter from Mr. Bettenberg saying that date has slipped, too.

Now, we get the letter from the contractor saying what I just read. It is saying this, "A Joint Test Plan was proposed to Minerals Management Service in late August; to date, we have no resolution."

"The poor condition of the test data environments supplied by Minerals Management Service makes it difficult to accurately schedule."

I have no date now. So we return to what Senator McClure said. You have the same systems you had three years ago. "This is true, despite the fact"—and this is the important thing—"despite the fact the oil and gas leases are the most valuable property on Federal and Indian lands," worth billions and billions of dollars.

"With the rapid escalation of energy prices and increased leasing, oil and gas royalties have risen from less than $500 million in 1971 to a more than estimated $5 billion in 1982." The projection for this year—how much last year was collected in royalties?

About two to five billion dollars, as I remember. $3.9 billion was collected as a Federal share. "Federal royalties from 17,866 onshore and 1,260 offshore oil and gas leases in 1981 alone produced $4 billion in revenues for the Federal Government."

"In 1980, the States which share in the revenues under the terms of the Mineral Leasing Act of 1920 received $315 million in royalty revenues." So this is not only a Federal problem, this is a problem for the States.

We have letters from the States and from Indian tribes saying that MMS does not know what it is doing, that there are big mistakes and it is reflected in the royalties that are due to the States and to the Indian tribes.

Then I continue with Mr. McClure's statement. "Yet, despite the obvious financial importance of oil and gas royalty revenues to all concerned, the Federal royalty management and collection system is in disarray. Hundreds of millions of dollars due to the U.S. Treasury, the States, Indian tribes, and individual Indian allottees are going uncollected every year due to inadequacies in the system."

UNCOLLECTED ROYALTIES

When Mr. Bettenberg testified last year he conceded the validity of the findings of the Linowes Commission in 1982 that there were five to ten percent of the royalties that were going uncollected. And the thing that really got me looking at it this year was our investigative staff's report, a copy of which I sent to you, to the Department of the Interior, which indicated that in a limited examination, a limited, regional examination, of four States and the MMS regional office, the loss may be in excess of 20 percent, at least for that limited area.

"Well, it will be said, but that is a limited area, Congressman, and it isn't applicable to the entire system."

If that is true, even if it is a very limited area, it should not happen in your system. You should not be losing 20 percent, assuming that that is right.

At any rate, I forwarded that on to you for comment. You have that before you.

[The Investigative Staff Study and Department of the Interior response follows:]

ROYALTY MANAGEMENT PROGRAM
DEPARTMENT OF INTERIOR

Background

The Royalty Accounting System (RAS) accounted for royalties up to 1983. The RAS was a lease-based system with data on a mainframe IBM 360 located in Reston, Virginia. In 1983, the RAS was replaced by the Auditing and Financial System (AFS). The AFS is a payor based system and is on several VAX mini-computers located in Lakewood, Colorado. Other companion systems to the AFS are the Bonus and Rental Account Support System (BRASS) and the Production Accounting and Auditing System (PAAS). The PAAS is currently on line only for all offshore oil and gas leases and a few onshore leases.

Royalty Management Program (RMP)

The Department's RMP has been beset with serious problems since 1959. The General Accounting Office, the Department's Office of Inspector General (OIG), the Commission on Fiscal Accountability, and Congressional probes made by the House Committee on Interior and Insular Affairs, and the Senate Select Committee on Indian Affairs have all been highly critical of the RMP in reports issued. These reports have outlined managerial problems and accounting system deficiencies affecting the Department's ability to collect all the royalties due from Federal and Indian oil and gas leases and to disburse the royalties to the appropriate recipient in a timely manner.

To address these problems, the Department, in 1980, contracted with Sterling Systems, Inc., and Arthur Andersen & Co. to design a system to replace the RAS. Arthur Andersen & Co. had recently completed the installation of a mainframe computer royalty management system for the State of Louisiana. In December 1980, Arthur Andersen issued their Preliminary System Design centering around a mainframe computer with a capacity of from 600,000 to 1,000,000 monthly lines and was asked by officials of the U.S. Geological Survey (USGS) to begin implementing the proposed AFS and PAAS.

Arthur Andersen & Co. officials advised that they brought in a 50-person team to Lakewood and began the task of developing the system based on their Preliminary System Design. They had estimated that the entire system, AFS and PAAS, which could utilize one of the existing three USGS mainframe computers, would be fully implemented by January 1983, at a cost of about $10 to $11 million. However, on March 31, 1981, Arthur Andersen & Co. was directed to leave the facility.

Decision To Utilize A Mini-Computer Rather Than A Mainframe

In April 1981, the new leadership within the USGS, completely resized the system needs and changed the computer size from the existing IBM 360 mainframe computer to a mini-computer format. This decision allegedly was catastrophic and forced the royalty management program into a survival mode.

In August 1981, the mini-computer contract was awarded based on an assumption that one VAX could handle both AFS and PAAS. However, in May 1982, with less than 10 percent of the workload installed, MMS knew that the VAX mini-computer system would not work. MMS continued to purchase additional VAX mini-computers to merely survive, even though it was apparent that the acquisition of additional VAX computers would never solve the problem.

In September 1982, about 1 year after the VAX contract was awarded, MMS, because of the apparent lack of capacity, began plans to abandon the VAX computers and go back to the mainframe concept advocated by Arthur Andersen and cognizant USGS officials. MMS' worst fears were confirmed in January 1983, when the VAX failed its first acceptance test because of the lack of capacity. This single misguided decision not only cost MMS about $50 million in contract costs, and delayed the implementation of a viable royalty management program by 4 to 5 years, but also diverted management talent from refining the system to merely making a bad system operate.

Planning Began For System X

In December 1982, MMS began studying the conversion of the yet to be accepted VAX mini-computer. In July 1983, the System X mainframe request for proposal and procurement package was prepared and submitted to the Department. In April 1985, the System X mainframe computer contract was awarded to Martin Marietta Corporation for about $32 million. The $32 million contract will provide for a mainframe computer, data base and software conversion from VAX to mainframe for AFS only, and operation and maintenance on the mainframe. The Investigative Staff was advised that the $32 million brings contract costs for a system to account for all royalties to about $80 million.

This contract with Martin Marietta Corporation has also encountered serious problems. The acceptance of System X has slipped from the original target date of April 1986 to October 1986, because the contractor has found the MMS data base to be in more disarray than was anticipated. Because of this slippage, the contractor has been assessed with penalties at the rate of $5,000 per day since December 1985.

System X Alone Will Not Solve All The Problems

MMS officials have advised that System X is not the panacea for the royalty management program. System X will continue to process, as one official advised, the same flawed data processed by the VAX, but only faster. The major System X benefits will be capacity and speed. To take full advantage of this capacity the AFS system must be enhanced and/or redesigned. The first block of these enhancements, estimated to cost about $400,000, are scheduled to begin in May 1986.

Although additional enhancements and redesign efforts are necessary, MMS officials would not provide information concerning cost estimates, the extent of the redesign planned, the anticipated timeframe, nor an estimate as to when the AFS will be fully in compliance with FOGRMA.

Designation of Mini-Computer Created Design Problems

The AFS was originally designed by Arthur Andersen & Co. to function on a large mainframe computer. When the contract was initiated with AMS in 1981, the VAX 11-780 mini-computer was stipulated as the hardware to be used. However, AMS used the data base design developed by Arthur Andersen & Co. for a mainframe computer even though it was not designed to function on a mini-computer. This resulted in both data base and operational problems. Two types of problems exist with the royalty management systems. First, data required for the three systems does not allow for auditing and fiscal accountability and secondly, processing of the data cannot fulfill the legal requirements for royalty management. Some required data are not collected, collected and not used, used, or not usable from the system. In addition, some information has not been programed for extraction from the system.

Inadequate and Inaccurate Data Bases

The AFS which began operating in December 1983, was a radical change from operation of the previous RAS. This radical change created problems in royalty management and some of them still exist today. The major changes and their impact are as follows:

- Conceptual change with reporting and royalty payment on a "payor" basis. This has resulted in loss of lease identity.
- Changing all reporting forms for collecting data has resulted in the lack of a relationship to previous data collection instruments.

- -- Changing from a large mainframe computer to multi-mini-computers. This has resulted in complete redesign of system and data bases.
- -- Single data base became a multiple data base system with implementation of the new mini-computer systems. These include the AFS, a reference data base, PAAS, and BRASS and presently operate on five VAX mini-computers.

Computer consultants advised that, normally, in large data base systems complete changes in concept, computers, and reporting are never implemented simultaneously because of the subsequent loss of continuity. This has occurred in the MMS data bases and computer systems. Exacerbation of this situation has occurred because of MMS' close working relationship with other agencies within the Department of the Interior; i.e., Bureau of Indian Affairs (BIA), Bureau of Land Management (BLM), and the Office of Surface Mining which maintain lease records.

Reference data submitted by payors includes information essential for identification of the payor, lease, revenue source, and selling arrangement. These data must be entered into the AFS before any reports, including Form 2014, are processed and money received by MMS can be distributed. The reference data base is complicated with multiple payors on a lease, numerous revenue sources on the same lease, and several selling arrangements for products sold from the lease. For example, one lease had two payors, 14 revenue sources, and four selling arrangements. When these data were reported each month on the Form 2014, there were 45 lines of data that had to be processed into the computer data base.

When a payor submits a Form 2014 and a check for monies owed the Federal Government, the MMS Revenue and Document Processing Section initially handles them. The data is keypunched and processed into the royalty VAX computer where the information is subjected to about 200 edits. A duplicate of the reference data base is part of the royalty data base and used in the edit process to determine "good" data which will allow the MMS to distribute the collected monies to proper accounts. Clean lines of data from the Form 2014's are periodically transferred to a third VAX computer which contains the financial data base. Therefore, the three VAX mini-computers containing the AFS data bases actually have duplicate reference data bases and duplicate data bases of Form 2014 data.

Although the MMS data bases have been operational since December 1983, it is necessary to continuously maintain, validate, and correct data in the three systems. For example, the reference data base is the mainstay of the RMP's automated systems (AFS, BRASS, and PAAS). In the AFS, the reference data is a complex aggregation of data elements and records that includes over 1,500 payors, 34,500 leases, 190,000 selling arrangements, and 95,000 revenue sources. This reference data base is extremely dynamic with over 30 percent of the data elements changing every year. This combination of payors, leases, revenue sources, and selling arrangements generates about 220,000 lines of data each month from the Form 2014. This does not include an additional 150,000 lines that will be put on the new mainframe computer with addition of El Paso Natural Gas Company. When El Paso is added the AFS will process about 400,000 lines of data each month from the Form 2014's.

Reference Data Base Errors Adversely Impact on RMP

The royalty management's reference data base was created by converting predecessor systems of the USGS and the BLM to the new AFS reference data base. This conversion was done without validation or reconciliation of these data bases. Also, these data bases had been poorly maintained over a long period of time. When the new automated accounting systems became operational, MMS discovered that many of the reference data elements necessary to properly account for and disburse rental and royalty collections were inaccurate. Examples of this include lease coding errors, incorrect distribution codes resulting in collections being disbursed to improper recipients, and inaccurate and incomplete information that does not provide for 100 percent of payment responsibility on a lease.

Together with the problems of an inaccurate and incomplete reference data base is the high volume of changes initiated by lease holders. For example, during FY 1985, royalty management received and processed approximately 7,000 leasing actions, 1,600 pooling agreements, and 30,000 payor information changes in the AFS and PAAS; and approximately 60,000 lease and payor actions in BRASS. These actions are generated from lease activity, such as new leases, unitization, communitization, new production, and terminations. Also, changes in paying and reporting responsibilities are generated from realignment of working interests, buyer/seller changes, and industry takeovers. This situation is further complicated by the interdependence of the MMS upon BIA and BLM to identify and report some of these conditions to MMS as well as MMS' responsibility to report some information to BIA and/or BLM.

The reference data base must contain the lease universe which is the heart of the royalty management systems. However, responsibility for oil and gas leases is fragmented within the DOI to three agencies (BLM, BIA and MMS). These responsibilities are:

-- BLM is responsible for issuing all Federal onshore leases (except Indian) including advertising, sales, collecting the bonus and first year rentals, approving assignments, performing inspections, enforcing regulations, verifying production, and controlling environment and surface disturbance activities. For Indian tribal and allottee leases, BLM is responsible for evaluation of bids made in competitive sales by post-sale evaluation of tracts. Also, BLM issues drilling permits and is responsible for receiving the "Monthly Report of Operations" from Federal and Indian lease operators. BLM also has other responsibilities relative to lease operations.

-- BIA is responsibile for advertising and conducting Indian lease sales; disseminating copies of approved leases to MMS, BLM, and lessees; approving assignments, unit agreements, and communitization agreements; collecting and disbursing rental and bonus payments; and depositing and disbursing monies received from MMS to Tribal Accounts and Individual Indian Money Accounts.

-- MMS is responsible for collecting rents and royalties and accounting for monies owed and paid on Federal leases, both offshore and onshore, and to Indian mineral owners. Also, MMS is responsible for leasing and managing the offshore leases including accounting for production and sales.

The lease contract between the lessor and the lessee is the document that controls every aspect of the operations on the land leased including royalty rates for production. Conditions of the lease, referred to as "lease terms," are incorporated in the reference data base and subsequently into the AFS. The royalty rate is one of the data elements vital to collecting monies from payors. However, the AFS is unable to use the rates included in the system. The AFS calculates a royalty rate based upon the sales and royalty quantities and values.

When data from the Form 2014's are entered into the royalty data base each month, the accuracy of the data is checked by some 200 edit routines. The errors discovered during this process result in lines of data being "rejected" because monies reported on that line cannot be distributed to the proper recipient. Each month these "fatal errors" cause about 8 percent, or approximately 20,000, of the processed lines being rejected. These rejected lines are manually searched for the type of error and, after determination of the cause for rejection, efforts are made to correct the line. This may require such actions as telephoning the payor or correcting the MMS reference data base.

MMS has not determined the cost of correcting these rejected lines of data. Between 50 and 60 percent of the errors were related to incorrect reporting by payors. It is important to note that the other 40 to 50 percent is related to MMS data base and system errors.

The MMS edit routines also generate a monthly list of "warning errors" in conjunction with the fatal errors. MMS officials stated that no action is taken on "warning errors." However, MMS has initiated a study of these warning errors and feels some of them should be included in the fatal error group. Normally, there are over twice as many warning errors as fatal errors. Combining the warning and fatal errors results in about 30 percent of submitted lines needing corrections.

Erroneous reporting by payors results in a charge assessed against the payor of $10 per line (on the Form 2014) per month. The Payor Accounting Branch (PAB) is responsible for all payor billing and it is considered the National Billing Service for MMS. However, MMS must develop exception processing, assess penalties, identify candidates for audit, initiate bills, and collect monies owed, before AFS will function properly and be able to provide PAB with information for billing purposes.

Other Deficiencies Affecting Federal and Indian Leases

The AFS system, as currently designed, is not capable of, nor is it handling, all types of Federal and Indian leases. The "leases" are those that have special conditions in the lease terms. These special conditions include penalties, joint ventures, recoupments, royalty rates (i.e., Blanchard Decision leases), etc. These data are supposed to be contained in the reference data base.

Adjustments Complicate a Complicated System

A very complicated technique has been designed by MMS for revisions and adjustments that payors may use in the AFS. In fact, there are 28 adjustment codes and 30 transaction codes, any of which may be used by a payor with each of 16 products. There appear to be very few system checks that would determine the validity or accuracy of any adjustment taken in conjunction with any transaction for any product. Of the leases analyzed, several unexplainable adjustments were found to be taken by payors. For example, in 1 month a payor took an adjustment for "incorrect volume reported" for royalty; however, there was not any data in that month for royalty due on the product. The net effect of this adjustment was to negate the royalty payment for the product. MMS officials advised that a payor may take any adjustment desired; and there is absolutely no check or audit made for validity, accuracy, or appropriateness of the adjustment, including the effect upon royalty owed to the MMS or monies credited to the payor.

Concern about these adjustments led to a request for a listing of onshore adjustments taken by each payor (company). Although the computer list did not have the total number of adjustments taken by each payor in FY 1985, it did show that adjustments were made by payors under all 28 adjustment codes. The incredible fact about the adjustments was that the total adjustments made to royalties by payors was $1,217,189,276 even though onshore royalty collections in FY 1985 were only $822,000,000.

MMS policy requires payors to submit a line of data on the Form 2014 which reverses the original line of data reported when they are making adjustments. The payor then submits another line of data with the adjusted data being reported. MMS officials could not explain why this policy is followed; payors could simply report the adjustment as an increase or decrease in royalties owed. This would reduce the number of adjustment lines MMS has to process by up to one-half. Reversing the original line of data reported also causes extra work for the payor.

On September 26, 1985, as part of the review of MMS' adjustment procedure for the RMP, four bogus 2014 forms were submitted. The purpose was to test the system and determine if the system would routinely process these "bad" adjustment lines. System edits flagged one of the submissions because the Investigative Staff had deliberately used two improper codes which an edit rejected. Another submitted Form 2014 was flagged with a warning, but the submission was allowed to enter the system. The other two submitted forms entered the system and were treated like proper accounts causing monies to be transferred as shown by the Form 2104.

On December 17, 1985, MMS was advised of the bogus adjustments and requested to provide the transaction history of the four adjustments. As of this date, MMS has not replied.

Untimely Resolution of Rejected Royalty Lines

MMS' AFS system processes about 220,000 lines of royalty data a month. In 1985, rejected lines corrected were averaging over 20,000 lines a month. This represents almost 1 month's processing.

On December 31, 1985, MMS had nearly 13,000 lines of data relating to Federal and Indian royalty payments which had been rejected (not processed). Nearly 8,000 of these rejected lines had not been processed for 30 days or more by the computer, because they were not able to meet various computerized edits. Furthermore, some of these lines had been rejected for as long as 819 days. The gross dollar value of the lines was about $64 million, comprised of about $32 million in positive dollars (amounts that may be owed to MMS), and $32 million in negative dollars (amounts that may be owed to the lessee).

The following MMS aging schedule, shows that some royalty lines have not been processed for considerable lengths of time.

Aging of Royalty Lines For Federal and Indian Leases Which Had Not Been Processed as of December 31, 1985

Age (Days) of Royalty Line Not Processed	Number of Lines	Positive Dollars Eliminated (000)	Number of Lines	Negative Dollars Eliminated (000)
1-89	4,345	$26,547	3,037	$-21,426
90-179	989	1,954	507	- 2,096
180-299	913	1,673	559	- 2,575
300 and over	1,454	1,516	994	- 6,258
Total	7,701	$31,690	5,097	$-32,355

Analysis of the aging data shows that most of the dollars not processed pertain to offshore leases. This is significant since in-so-far as positive dollar lines are concerned, over $24 million of the royalty money has been deposited in a Treasury escrow account #14F3875 which is used by MMS to hold the money until it can be transferred into the proper account.

The following schedule shows the rejected royalty lines as they relate to Indian and Federal onshore/offshore leases:

Composition of Rejected Royalty Lines by Type of Lease as of December 31, 1985

	Federal			
	Onshore	Offshore	Indian	Total
Number of lines	5,640	1,156	905	7,701
Positive dollars	$6,272,740	$24,248,081	$1,167,264	$31,688,085
Number of lines	2,319	902	876	4,097
Negative dollars	-$2,553,885	-$29,028,758	-$ 677,962	-$32,260,605

System Output

Output from the present mini-computer and the new mainframe computer, when it is operational, can be divided into two major categories; namely, needed by MMS for internal program management and by users outside of MMS. The MMS system requirements revolve around proper accounting and distribution of monies received. Legislation has placed an additional requirement that all monies owed are collected in a timely manner. MMS officials advised that neither the present mini-computers nor the new mainframe computer will fully comply with the legislation. Major enhancements and/or redesign will be required before the mainframe computer can fully comply with legislative mandates.

Numerous outputs have been developed for internal use by MMS. Exception processing, late payment, and improper reporting are the only operational routines. Other outputs include statistical reports, such as those in the MMS Monthly Activity Report; PAAS processing comparing AFS data for sales of some payors with production reported by operators; various Royalty Compliance Division outputs for auditing purposes; revenue and document processing; and ad hoc requests by MMS personnel. These outputs are used by MMS to control the collection and disbursement of monies owed the Government and the Indians.

Outputs for States and Indians from the computer are the other two principal requirements of the AFS. Information about monies owed the States is provided monthly in the Explanation of Payments (EOP). Also, on request, special routines can provide the State with payor data for a specific lease. The EOP has summary data showing disbursements to the States. However, State auditors advised that they cannot reconcile the amount paid the State with the EOP and the amount received by the MMS. Apparently, these discrepancies are caused by all the adjustments, allowances, interest, and system problems not fully explaining the collection and disbursement of monies owed the State.

The MMS provides information to the Indian tribes and the BIA for Indian allottees on the Indian Distribution Report. The BIA then combines the MMS explanation of monies disbursed with monies received by the BIA and owed to the same Indian allottee or tribe and the BIA pays by check, the total amount going to the recipient. Again, information sent to BIA by MMS is often inaccurate and contains no production data, sales quantity, or royalty rate. Errors were found in data reported by payors and passed on to BIA, as well as system problems which resulted in incomplete and sometimes inaccurate information provided to BIA.

The States and Indian tribes will be provided direct access to the AFS data on the mainframe computer through the State and Tribal Support Systems. State auditor offices, tribal offices, and selected BIA area offices are being given computer terminals. These terminals will make available a down loaded data base to the States and tribes and provide a report generation system to them. For security of proprietary data, the system will be password protected and allow access only to data relevant to the State or tribe. This system was expected to be operational by April 30, 1986.

The MMS Honor System Is Ineffective

Because MMS has no means of verification, the royalty management systems operates on the "honor system", depending on the veracity of the lessee to submit the correct data. Like the Internal Revenue Service (IRS) system, which MMS purports to emulate, the data would be processed and accepted subject to audit. The difference between the MMS and the IRS' system lies in MMS's inability to identify those payors who should be subject to audit. Furthermore, the MMS systems lack the capability to identify the royalty underpayments, nonpayments, royalty rates, product verification, etc. In fact, MMS has now adopted a "modified" IRS approach as follows:

- Reports received are considered as accurate but subject to audit.
- MMS will not calculate royalties due based on sales reports.
- Arithmetic will be validated.
- Exception processing will be one way of identifying potential candidates for audit.
- Audits will be performed at the discretion of MMS.

The success of an IRS system is somewhat based on "fear." Also, IRS immediately imposes interest and penalty charges. MMS has just recently begun imposing charges for late payment and is still studying penalty charges. Perhaps what a lessee/operator told the Montana State auditor puts the honor system and the IRS system in perspective. This chronology is as follows:

Prior to August 2, 1977	Lessee was paying Federal royalties on a value of $0.18/MCF or less for natural gas.
August 2, 1977	The Acting Area Oil and Gas Supervisor of the USGS, Casper, Wyoming, ordered the lessee to compute Federal royalties for natural gas using the Federal Power Commission Ceiling Price of $0.53/MCF on production from wells spudded prior to 1973. Lessee appealed to the Director of MMS.
December 11, 1984	The Director of MMS in a decision titled MMS-77-0005-IND, concluded that the lessee should calculate Federal royalties as ordered by the Acting Area Oil and Gas Supervisor, Casper, Wyoming, in the August 2, 1977, order.
August 14, 1985	Auditors from the Montana Department of Revenue, discovered that the lessee was paying Federal royalties based on natural gas values ranging from $0.21/MCF to $0.28/MCF. This was for the same areas that were covered by the August 2, 1977 order.
October 8, 1985	The lessee called the Montana auditors and informed them that he agreed with the assessment and would pay. He also said that he was aware of the August 2, 1977, order and the follow-up decision by the MMS Director. However, he had decided to wait until MMS forced him to pay before making any adjustment to prior period royalty payments, or started paying the current royalties based on the Director's order.

October 11, 1985	Montana auditors became aware on December 30, 1980, that the lessee had settled with the State of Montana Commissioner of State Lands to compute natural gas royalties for State lands on a value of $1.75/MCF to $1.85/MCF until October 1980, and thereafter use the Natural Gas Pricing Act, Section 109 Price.
	This settlement is for royalties on State lands that are in the same fields as Federal land, and in some cases the gas may be from the same well bore as Federal gas which is being valued at $0.53/MCF or less for Federal royalty purposes.

Substantial Amounts of Oil and Gas Royalties May Be Underpaid

Previous studies regarding the Department's royalty management program indicated that as much as 7 to 10 percent of royalties owed go unreported. Cognizant officials advised that based on their experience, royalties of about 5 to 10 percent go unreported.

The audit organization of MMS and the States of Colorado, Wyoming, North Dakota, and Montana were asked to determine from their audits of oil and gas royalties, the percentage of unreported royalties. The auditors, for the periods audited, were to determine the amount of royalties the companies had paid and the amount of unreported royalties disclosed during their audits.

Since the amount of royalties paid since 1979 were not part of the audit tracking system and the expenditure of substantial manpower would be required, the auditors suggested that only audits completed in FY 1985 be included in their test. This test represented about 25 percent ($41 million of the $164 million) of the unreported royalties disclosed since inception of their audits in 1981.

The following schedule summarizes the details of the various audit groups:

SCHEDULE INDICATING PERCENTAGES OF UNDERPAID ROYALTIES BASED ON A COMPARISON OF AUDIT RESULTS WITH ROYALTIES PAID BEFORE THE AUDIT

Audit Group	Amount of Audit Findings or Collections	Amounts of Royalty Paid Before Audit	Percent of Underpaid Royalties
MMS--Regional Compliance Office	26,647,005.15	125,680,207.17	21
State of Wyoming Auditors	5,190,366.59	15,042,221.27	35
State of Colorado Auditors	5,224,190.00	40,015,041.00	13
State of North Dakota Auditors	3,387,327.00	8,504.147.00	40
State of Montana Auditors	514,828.00	2,422,225.00	21
TOTALS	$40,963,716.74	$191,663,841.44	21

Applying the 21 percent of underpaid royalties to the $28 billion of royalties collected by the Department since 1979, indicates that as much as $5.8 billion in royalties may be underpaid by the holders of Federal and Indian oil and gas leases.

Audits Have Identified Over $278 Million in Owed Royalties

The audit responsibility for oil and gas royalties is shared by the Royalty Compliance Division (RCD) of MMS, FOGRMA Section 202/205 cooperative and delegated audits to States and Indian tribes, and the Department's OIG. From October 1981 through September 1985 audits have identified over $278.5 million of additional royalties due. Included in this amount is $114.6 million identified by OIG look-back audits.

In addition to the $278 million, an additional $20 million has been identified by the OIG in their review of gas processing plants. No assessments have been made by the Department because MMS is still reviewing the OIG findings.

The aforementioned audit findings have been categorized into the following deficiency areas:

Incorrect pricing	$ 67,787,994
Incorrect production	24,733,368
Incorrect royalty rate	21,436,000
Dual compensation - gas valuation	2,004,866
Failure to report or pay on production and/or sales	10,782,000
Failure to pay rent and/or minimum royalties	121,000
Incorrect gathering, manufacturing, or transportation allowances	12,062,755
Comparing sales reports to royalty reports	25,563,000
Valuation natural gas liquids	3,849,125
Miscellaneous computational errors	7,191,197
Gas sales for use in lease sales	85,925
Late payment charges	26,723,801
Liquidated damages	457,000
Royalty on take-or-pay	38,653,397
FERC order 94, 94A, and 94B	21,564,881
FPC opinion 699-H gas pricing	14,853,157
TOTALS	$277,869,466

Included in the RCD identified owed royalties, are $35.6 million identified by Joint Federal and State and States 202/205 audits. Of the $35.6 million, $34.4 million was the result of the aggressive "junk-yard dog" efforts in the States of Wyoming, Colorado, and North Dakota. These State auditors advised that everything they looked at resulted in additional royalties owed. The State of Wyoming, alone, accounted for $25 million in recoveries.

The Chief of the RCD advised that he expects his auditors and the State auditors to recover about $25 for every audit dollar invested. This aggressive effort is vital to the success of the RMP and is one of the most successful aspects of MMS' so-called modified IRS concept.

North Dakota Tracking System

The State auditors of North Dakota (Section 205) have established a tracking system for their 450 Federal leases. This system records all production and sales for each lease. The auditors compare their figures with sales figures reported by the payor on the MMS Explanation of Payment Report.

The North Dakota auditors were requested to track the 150 Federal oil leases on public land and 300 oil leases on Federal acquired land. The results of their audits indicated that, for the period December 1983 through September 1985, about 180,000 barrels of oil, with a royalty value of about $1 million in the 150 Federal leases, had been under-reported; and about 600,000 barrels of oil production, with a royalty value of about $3 million, had been under-reported on the 300 acquired land leases.

Lease 255-030981

By request, State auditors also audited lease 255-030981, which reflected, as of November 30, 1983, a RAS credit balance of $1,273,099.53. In other words, the lessee was due a refund of that amount. The RAS statement of account analysis also indicated that the lessee, in order to reduce the credit balance, submitted an adjustment indicating that the lessee had failed to report 252,227 barrels of oil and that the credit balance should be reduced by $1,023,673.58. The lessee also made other adjustments which reduced the credit balance to $246,698.89.

On February 5, 1986, the North Dakota State Auditor advised the lessee in part that:

> "We have reviewed the oil sales from Federal lease 255-030981 for the period November 1979 through December 1984. This letter is intended to apprise you of a preliminary royalty underpayment. * * *
>
> "Our review indicates that for the period November 1979 through December 1984, * * * underpaid oil royalties due MMS by $46,609.59. In addition, our review shows that $307,357.30 was paid on this lease which should have been paid to Federal lease 284-031008."

In other words, instead of the Government owing the lessee $246,698.89 the lessee was billed and paid the Government $46,609.59.

Payors Deny Access to Records

In several of the OIG look-back audits conducted by certified public accounting (CPA) firms under contract to the OIG, the CPA's were denied access to records necessary for the conduct of the audit.

Section 103(a) of FOGRMA states in part:

> "Upon the request of any officer or employee duly designated by the Secretary or any State or Indian tribe conducting an audit or investigation pursuant to this Act, the appropriate records, reports, or information which may be required by this section shall be made available for inspection and duplication by such officer or employee, State or Indian tribe."

In the OIG audit report, dated March 1984, "Audit of Federal and Indian Oil and Gas Royalties paid by Chevron, U.S.A., Inc., for the period from January 1, 1977, through August 31, 1981," approximately $12.1 million in additional royalties due MMS was identified.

In addition to the underpayment, the OIG took strong exception to Chevron refusing access to records necessary for the proper conduct of the audit. In his transmittal letter, the OIG stated that:

* * *

> "Chevron refused to produce the records in support of NGL [Natural Gas Liquids] royalty computations and sales prices during the period of DOE price control and continually asserted that NGL values upon which royalties were paid and the NGL sales values were computed in accordance with DOE regulations.
>
> "Chevron also refused to produce the records supporting advance payments, copies of all advance payment contracts, advance payment recoupments, and unrecouped advance payment balances. Chevron's position in not providing the records in support of NGL royalty values and sales prices, and advance payment contracts is that Chevron has provided sufficient information to support the basis upon which royalties were reported and paid, and that the requested records are not a relevant factor in royalty determination. The Office of Inspector General takes exception to this

position. Any record relating to royalty value, production, or sales is subject to examination, and liquidation damages should be assessed against Chevron for failure to provide the records. Until the required records are provided and MMS examines and evaluates the NGL computations and advance payments, there is no assurance that Chevron calculated and paid royalties in an accurate, consistent, and lawful manner."

In another look-back audit conducted by a CPA firm on Atlantic Richfield Company (ARCO), dated August 16, 1985, the report also stated the following regarding access to records:

> "Procedures outlined in the program were not performed for take-or-pay receipts as we were not allowed access to certain production information, receipt dates, or purchaser information."
>
> * * *
>
> "During testing, we requested that ARCO supply information regarding any "advance gas payments" received on Federal and Indian leases. ARCO refused to substantively address any questions regarding these payments, and accordingly, procedures as outlined in the work program could not be performed."

In both cases the capability to do the audits was seriously hampered. MMS officials advised that MMS and the Department have not taken any action on this matter, other than to offer that they are studying an appropriate strategy.

Ineffective Reconciliation Effort

Although the audit aspects of RCD have been very productive, equally nonproductive has been their effort to reconcile RAS balances. The RAS balances are the residue of the accounting system before MMS adopted the current AFS. FOGRMA required that the estimated 22,600 RAS balances be audited and reconciled. RCD's definition of reconciliation, which does not assure that the account is correct, is as follows:

> "Analyzing the debits and credits for a lease, with the objective of determining whether any missing or misapplied charges or payments should appear on the Statement of Accounts. The reconciliation is an expedient means of confirming whether royalty computations based on reported sales agree with royalty payment. Reconciliation does not include audit steps; i.e., verifications of production volumes, of product values, and other steps

that may in the judgement of the auditor be necessary to verify that all amounts due have been paid."

The reconciliation effort merely involves the running of an adding machine tape verifying that the account's debits equal its credits.

The ineffectiveness of the reconciliation effort is dramatically demonstrated by audits of the following five Indian leases. Each of the five leases had their balances reconciled. The reconciliation showed that the lessee was owed money by the Indian landowner. The leases were subsequently audited and showed the reverse, that instead of the Indian landowner owing the lessee money, the lessee owed the Indian landowner additional royalties.

The following is a comparison of these five leases that were first reconciled and then audited.

Contract or Lease Number	Reconciliation Which Indicated Lessee Due Refund	Audit Which Indicated Lessee Owed Additional Royalties
14-20-0207-1108	$ 82.79	$ 18,625.41
14-20-0207-361	58.83	807.86
14-20-205-7628	104.20	51,565.16
14-20-205-7629	202.83	15,091.25
518-000592*	622.02	5,901.50

*In addition to the $5,901.50 of royalties owed by the lessee, an additional $21,002.84 in lessee underpayments is currently under review by MMS.

The RAS balances were reportedly absolutely meaningless, yet as part of the reconciliation program these balances actually became criteria. RCD has determined that any RAS balances below $100,000 should not be audited.

RCD had reportedly submitted a position paper which, as one of its options, was to eliminate doing reconciliations and the use of the $100,000 RAS balances as criteria. The RCD proposed doing audits based on account activity and ignoring the meaningless $100,000 balance. MMS, however, has continued to do reconciliations and "expedited reviews" which are even less effective than reconciliations.

As of February 13, 1986, of the 22,600 producing Federal and Indian leases only 2,688 have not been reconciled. State auditors advised that performing reconciliations is a waste of valuable resources which can be more productively utilized by doing audits.

Additional Revenues Collected by MMS for Erroneous Reports and Late Reporting

MMS started assessing payors for submitting erroneous and late reports. In the case of assessments for erroneous reporting, MMS began charging those payors having a 7 percent error rate and a minimum of 25 lines submitted in error (error is a condition caused by the payor which causes the line to be rejected) $10 per line. This began in March 1985. Then in July 1985, the 7 percent error rate criteria was changed to 5 percent. After October 1985, the criteria was changed to the present policy which is basically a payor error rate of 5 percent or more and three lines or more in error. MMS' maximum assessment per month, per payor code, is $10,000. As of February 15, 1986, MMS had billed over $360,000 for erroneous reports with about $106,000 being billed in FY 1986.

Late reporting assessments began in May 1985. Each line of data on a Form 2014 is subject to assessment, unless it is an adjustment or estimate line. Assessments for late reporting are at the rate of $10 per line with a 3 line minimum. With the September 1985 report, no grace period was given by MMS. As of February 15, 1986, 410 assessment bills for late reports have been made for about $192,000, with nearly $97,000 being billed in FY 1986.

Analysis of Nine Leases

A cursory analysis of nine leases was conducted during this investigation. The analysis included the verification of production and, where possible, the MMS Form 2014 data were compared with data from the BLM "Monthly Report of Operations" (Form 9-329) and/or Petroleum Information Corporation (PI) Denver, Colorado, production data system. Petroleum Information has been a commercial source of information for production, liquid sales, and individual well data since the 1950's. In general, data reported by operators to the BLM was the same or approximated data in the PI data system. In analyzing the MMS payor data, some of the data was substantiated from the other sources. However, for some leases there were substantial discrepancies, plus incorrect or unsupportable data on the Form 2014 lines reported to the MMS.

Lease 039779-A - The operator reported significantly larger volumes of gas production and sales to BLM than was reported by payors on the sales reports submitted to MMS. BLM natural gas sales volumes were three times the amount reported to MMS in 1984. Using gas values reported to MMS by the payor on this lease, gas sales were underreported by about $1,960,010 in 1984 and by $429,615 in the first 11 months of 1985.

Lease 034544 - It was determined that underreporting occurred on both condensate (oil) and gas. In just 7 months of 1985, the condensate was underreported to MMS by $130,325. In addition, when allowances are made for Natural Gas Liquids (NGL) extraction, the gas sales were estimated to be underreported by about $912,000 for the 7 months of 1985.

Lease 059547 - The payor used incorrect quality data in calculating royalty due. For example, the payor used 1,100 BTU per MCF for unprocessed gas when actual gas analyses were 1,700 BTU per MCF. As a result, in 1984 and in the first 7 months of 1985, gas sales were underreported by $153,039 and $87,724, respectively. The payor has many other leases in the field and could be using the incorrect BTU value for all the gas produced.

Also, the operator reported to the BLM on Form 9-329 production and sales of oil; however, part of the production (from some wells) was not accounted for on reports to the MMS. In one month $5,447 of oil sales was underreported from this lease.

Lease 000682 and 013306-A - Over reporting of sales to the MMS occurred on these two leases. Apparently, the payor is including production from other wells (leases) on their Form 2014. On both these leases the information reported to PI and BLM are identical for production and sales.

The MMS lease history computer printout is an important tool in the audit of leases. It is, however, complicated by continual adjustments and allowances which makes it very difficult to determine actual royalties due or paid by a payor. This is further complicated where there are multiple payors on one lease. For example, in 1 month on one lease a payor reported six lines of data on the Form 2014 for royalty due MMS, and there were 29 additional lines of adjustments and allowances.

Also, value data reported on the Form 2014 was found to be incorrect. It was impossible to relate value per unit to actual value without auditing a payor and/or lease. Obvious errors were found during the lease analyses, where residue gas value was reported as $.09 and $.03, and $294.17 per MCF. The first two are obviously too low and the other too high. There are also wide ranges of residue gas values from the same lease during any 1 month (i.e., $2.95 to $4.11 per MCF; $4.07 to $7.74 per MCF; $3.08 to $6.34 per MCF; and $4.25 to $8.68 per MCF). Audits appear to be the only way to ascertain the validity of these values for sales of the residue gas.

Information from the BLM and PI production data systems was used to determine how these two sources of production and sales compared with information reported to the MMS by payors on the Form 2014. Both BLM and PI data are excellent sources for production verification. Where data collected by PI and the BLM could be compared, they generally contained identical data, even at the individual well basis. One lease, number 039779-A, in the PI system was lower than that reported to the BLM for the production and sales of condensate. The gas production reported for this lease was indentical in the PI and BLM reports. On two leases, 034544 and 034547, the BLM Form 9-329 did not contain data for a producing well. Where there were other producing wells on the lease, the BLM and PI production and sales were identical.

Average Prices for Crude Oil Indicate Lost Revenue

The relationship between the average price of crude oil and the average price received for crude oil produced from Federal and Indian leases was examined. These comparisons were made in selected States. In some States prices were quite close, while in other States prices for crude oil from Indian leases were significantly lower than the averages for the State. An assumption is made that prices received for Federal and Indian crude oil should, in general, be the same as the average price received for all crude produced in the State. This assumption is believed to be valid where the Federal and Indian crude oil is a substantial part of the States total production and the crude oil quality is comparable. These comparisons were made for six western States for 1978 through 1983. Summary data which shows the differences between averages paid in the State and the average of what was paid for Federal and Indian crude oil is as follows:

Colorado: Approximately one-third of Colorado's crude oil production is from Federal and Indian leases. Large disparities exist in the average price paid for Federal and Indian oil in comparison with the State average. The State auditor advised that undervaluation has been identified as a problem in Colorado.

The chart below identifies these disparities for the period 1978-1983:

Year	Federal Price Differential From State Average	Indian Price Differential From State Average	Federal Differential Value	Indian Differential Value
	$ per barrel			
1978	$ .98	$6.25	$ 11,962,892	$ 575,744
1979	2.24	1.46	24,000,527	77,733
1980	4.83	3.64	47,250,122	197,070
1981	2.13	6.27	20,615,386	415,018
1982	4.07	0	37,126,499	0
1983	3.22	2.26	32,683,966	116,546
TOTALS			$173,639,392	$1,382,111

Based on these data and assuming a 12.5 percent royalty rate, royalty lost could be $21,704,921 from Federal leases and $172,764 from Indian leases over the 6-year period.

New Mexico: Crude oil, including condensate, produced from Federal and Indian leases received a higher average price than the average price received for all oil produced in New Mexico. Approximately one-third of New Mexico crude oil production is derived from Federal and Indian leases. There are two areas of oil and condensate production. The two areas are in southeastern and northwestern New Mexico. In the northwestern area, referred to as the San Juan Basin, production is generally higher gravity oil and commands a higher price than the southeast production. This area also contains most of the Federal and Indian oil production; therefore, the average price of Federal and Indian oil production would be higher than the State average.

North Dakota: Approximately one-third of the North Dakota oil production is comprised of Federal and Indian oil. The Federal crude oil average price was generally higher than the State average price while the Indian oil price was lower. For the 6 year period $212,425 of royalties could have been lost from Indian oil production. Also, in 1982 and 1983, the Indians did receive about the same price as the State average.

Oklahoma: Federal and Indian crude oil production comprises just over 2 percent of the total crude oil production in Oklahoma.

The chart below illustrates the price per barrel differences during the period 1978-1983:

Year	Federal Price Differential From State Average	Indian Price Differential From State Average	Federal Differential Value	Indian Differential Value
	$ per barrel			
1978	$ 0	$0.33	$ 0	$ 1,462,196
1979	3.06	1.30	679,142	4,629,525
1980	2.96	4.14	570,907	15,232,571
1981	15.85	1.14	4,911,915	3,849,900
1982	10.81	0.94	4,187,837	3,237,402
1983	0.17	0.42	72,624	1,417,542
TOTALS			$10,422,425	$29,829,136

Based on these data and assuming a 12.5 percent royalty rate, royalty lost could be $1,302,803 from Federal leases and $3,728,642 from Indian leases.

Utah: About one-half of the crude oil production in Utah is derived from Federal and Indian leases. Average price for Federal crude oil is below the State average price and so were the Indian crude oil prices in 1978, 1979, and 1980. However, for 1981, 1982, and 1983 the average price for Indian crude oil was higher than the State average.

The chart below depicts those disparities for the period 1978-1983:

Year	Federal Price Differential From State Average	Indian Price Differential From State Average	Federal Differential Value	Indian Differential Value
	$ per barrel			
1978	$3.19	$1.61	$ 18,366,326	$17,644,907
1979	3.20	1.02	16,696,451	11,491,794
1980	4.95	2.36	26,519,743	22,650,522
1981	2.96	0	16,995,819	0
1982	5.78	0	37,238,199	0
1983	2.05	0	9,973,250	0
TOTALS			$125,789,788	$51,787,223

Based on these data and assuming a 12.5 percent royalty rate, royalty underpayments could be $15,723,722 from Federal leases and $6,473,402 for Indian leases.

Wyoming: Almost 60 percent of the Wyoming crude oil production is derived from Federal and Indian leases. Average price for Federal crude oil is comparable with the State average price. However, the Indian crude oil average price which is all from the Wind River Reservation was below the State average.

Year	Indian Price Differential From State Average $ per Bbl.	Indian Differential Value
1978	$2.50	$11,866,610
1979	2.48	12,314,896
1980	4.69	22,695,069
1981	6.64	38,143,108
1982	1.26	5,544,480
1983	1.27	5,712,460
TOTAL		$96,276,623

Based on the data and assuming a 12.5 percent royalty rate, royalty underpayment could be $12,034,577 from Indian leases. The Arapahoe and Shoshone Tribes have reportedly instituted lease cancellation actions against the lessees because the lessees failed to account for royalties due and owed to the tribe.

Collection of Interest and Payment of Interest

FOGRMA Section 111 (P.L. 97-451) requires the charging of interest for late payments. In addition, FOGRMA requires MMS to pay interest

- to a State when royalty money is not paid by the last business day of the month in which such money is warranted by the U.S. Treasury as having been received; and
- to Indians when the royalty money collected is not paid into the appropriate Indian account by the end of the month in which it is received.

In FY 1985 MMS collected interest payments from payors totaling about $14 million. The States share interest was $3.7 million, the U.S. Treasury received $9.7 million, and the Indians about $584,000. Interest payments from public land are shared equally with 50 percent going to the States and 50 percent going to the general treasury. Interest on acquired land and Outer Continental Shelf (OCS) leases all goes to the General Fund of the Treasury. At the same time, MMS was obligated to pay interest of $1,051,038 to the States and $102,690 to BIA.

While the royalty accounting was being centralized in Lakewood, Colorado, FOGRMA was passed by Congress in January 1983, with an effective date of October 1, 1983. FOGRMA's requirements conflicted with the original design of the AFS. Specifically,

- previous semi-annual disbursements were changed to monthly disbursements,
- disbursements would have to be tied to cash receipts, dates, and
- interest was to be paid on late disbursements.

MMS was able to effect the change from semi-annual to monthly disbursements. However, the AFS system still could not accurately calculate and pay interest based on cash received because such receipts could not be tied to specific disbursements. Accordingly, for computing interest owed to States, MMS decided to use the date the Form 2014 was received and compare it to the eventual disbursement date. This rationale was based on the assumption that, in most cases, an appropriate amount of cash accompanied the Form 2014.

Indians present a special problem for MMS because FOGRMA requires royalties to be deposited in the appropriate Indian account by no later than the last business day of the month in which such funds are received. Most royalties are received during the last 3 days of the month. This does not allow sufficient time for MMS to process the Form 2014's and to identify the leases where the money should be distributed; i.e., distinguish between tribal and allottee, etc. MMS' interpretation of FOGRMA requirements for royalties distributed to States results in MMS not having to distribute such money until the month following the month of receipt.

Because of FOGRMA's requirement for Indian oil and gas royalties to be deposited to the appropriate Indian accounts by the end of the month in which they are received, MMS is in the position of nearly always having to pay interest on Indian royalty payments. However, MMS and BIA have taken steps to have Indian royalty payments invested into interest bearing accounts as quickly as possible.

The method used by MMS and BIA to handle the deposits of Indian royalty monies in conjunction with FOGRMA's requirements results in MMS paying interest (paid at the end of the fiscal year) on money that BIA has already invested. Additionally, MMS does not provide BIA with information which enables BIA to identify those Indian leases to which the interest should be applied. Further, BIA officials stated that BIA is not able to credit investment interest earned to the appropriate lease. Rather, BIA distributes the interest based upon individual month-end tribal and allottee account balances. As a result, some Indians receive interest overpayments while others are underpaid.

In June 1985, MMS requested an opinion on the legality of Indian tribes and allottees benefiting from interest paid by both MMS and BIA on the same monies and for the same period each month.

MMS has been billing payors interest when their payments are late. However, MMS does not bill if the interest owed is $25 or less. In addition, in its processing of late payment interest billings, MMS starts with the highest amounts first (by Federal and Indian). This process means that some late payments are not charged interest because MMS is not able to review and bill them.

For example, in FY 1985, there were about 931 potential billings for $1.4 million that were not reviewed and consequently not billed.

MMS did not begin billing payors for late payments until February 1985 (Federal leases) and April 1985 (Indian leases). However, MMS has contracted the function with International Business Services, Inc., to go back to October 1983, and bill for late payments MMS has not billed.

Noncompliance With FOGRMA

The Department has not fully complied with the intent of the Federal Oil and Gas Royalty Management Act of 1982 in the areas of production verification, valuation guidelines, and assessment of penalties.

Production Verification Is Not Being Done

The Department of Interior has fragmented the RMP between three agencies: BLM, BIA, and MMS. Fragmentation of responsibilities and requirements for industry reporting has been further complicated by conceptual differencies in the agencies. In BLM and BIA, reporting is on a lease basis as controlled by lease operators; whereas MMS depends on royalty payors established by lease revenue sources and product selling arrangements. All of this results in duplicate reporting and duplicate data in the three agencies. Production verification and requirements for reporting production is so fragmented that even though the information is reported to BLM, the data are not provided to BIA, nor MMS. The data reported to MMS are quantities *sold*. FOGRMA requires the Department to provide a State, Indian tribe or Indian allottee a "description of the type of payment being made, the period covered by such payment, the source of such payment, production amounts, the royalty rate, unit value, and such other information as may be agreed upon by the Secretary * * *." Most of these data are *not* provided to the recipients; in fact, some of the information *is* not even collected.

Officials in BLM stated that *BLM has done no production verification*. On October 18, 1985, the BLM Deputy Director, Energy and Mineral Resources, issued Instruction Memorandum No. 86-29 (IM 86-29), "Interim Policy on Inspections for Production Verification Purposes." IM 86-29 instructs BLM State Directors "* * * that the more detailed production verification routines described herein are to be performed annually on at least 15 percent of those leases, communitized tracts, and unit participating areas which presently produce a significant volume of oil and/or gas * * *." However, only anomalies found are to be reported to MMS and this certainly will not verify production in relation to the volumes reported by payors to MMS. The Investigative Staff provided a copy of IM 86-29 to officials at MMS. None of the MMS officials had seen the IM, nor had BLM consulted with MMS concerning production verification. Of more importance were comments of the MMS officials that they do not know what they will do with the information if and when BLM gives it to them. The data cannot be input into the MMS computer systems because it is not payor specific.

Production Verification Available From Commercial Sources

Production of oil and gas and associated products from wells and leases is fundamental to the industry, mineral owners, purchasers, and consumers. Therefore, this production is measured at each point along the way by the concerned parties. The producer measures the well output in order to know how much he has to sell, while the purchaser measures the quantity so he will know the amount to pay. These requirements generate several sources of production data varying from individual company production and accounting records through purchasers, State and Federal Government, and commercial information services.

Data from a commercial service which compared favorably with the production and sales data reported to BLM was used in this facet of the investigation. Both BLM and PI are individual well specific. Production from each well was aggregated to the lease level. PI has developed production verification systems for oil and gas producers and PI officials advised that these systems pay for themselves in 3 to 5 years. PI prepares the electronic tape of Form 2014 data filed by a major producer with the MMS.

These commercial data obviously are available to any users needing and willing to pay for the information. PI officials analyzed the requirements for production verification and advised the that PI could develop a production verification system compatible with the MMS Auditing and Financial System. This production verification system, utilizing the PI production data, could be developed by PI for an estimated $1,200,000. Depending on method of operation, the new system could be operated by PI for between $10,000 and $100,000 per month. The PI production data system maintains individual well data back to 1969. Also, PI has a well record service and data system which tracks all wells drilled in the United States from drilling permit to abandonment or production.

Lack of Valuation Guidelines Has Created Confusion

A top priority requirement for MMS has been to establish standards for valuation for the industry. Ever since MMS was created in January 1982, it has been attempting to publish valuation guidelines. A major concern of the industry has been, and continues to be, the lack of product value guidelines/regulations. One of the Linowes Commission recommendations calls for the Department of Interior to publish product value guidelines for industry use. Lack of guidelines has caused audit findings to be set aside (El Paso case, for instance, was over $10,000,000); State auditors under FOGRMA Section 205 applying improper product valuation; industry not knowing what value to place on products; as well as other problems.

Regulations governing the valuation for royalty purposes of coal, oil, and gas and associated products from Federal and Indian leases are codified in various sections of Title 30 and 43 of the Code of Federal Regulations. In addition, other regulatory and related provisions are included in various Notices [illegible]sees and Departmental Orders. MMS finally has drafted reg[illegible] in five separate areas; coal, oil, gas and associated [illegible]s, gas processing allowances, and transportation allowances. Each draft is in the form of a notice of proposed rulemaking, including proposed regulatory language and a preamble. Because the issues related to product valuation are so complex, MMS has decided to make drafts of the proposed regulations available for public review and comment before issuing formal notices of proposed rulemaking. Four of the five draft regulatory packages are being made available for comment in February 1986; the draft rule for gas and associated products will be available a few weeks later.

Officials in the MMS Royalty Valuation and Standards Division stated that the valuation guidelines should have been the top priority of the Department since January 1982. The Linowes Commission recommended that valuation guidelines be published by July 1983. The Valuation and Standards Division began developing guidelines in early 1982 and in November 1982 published guidelines for valuing oil in the Federal Register for public comment. In May 1983, draft guidelines for valuing gas were completed and released for industry comment via the American Petroleum Institute. However, no final regulations have been published. MMS officials advised that many changes in top level management with different philosopies and ideas about valuation of production for royalty purposes caused continual revisions and changes of submitted guidelines. This lack of action in publishing regulations may wind up being very costly for the Federal Government.

Industry representatives also advised that lack of value regulations and guidelines has been the single most important issue in the payment of royalties. Industry representatives commented that without regulations industry pays royalties as they perceive the regulations while MMS has been collecting royalties based on its perception of product valuation. This has caused mass confusion. Also, State auditors advised that they have the same valuation problems conducting audits. Still with all this confusion, regulations will not be inacted until late 1986 and some in 1987.

Draft Regulations

Three of the draft valuation regulations deal directly with the value of production for the purpose of computing royalty and two of the regulations are concerned with allowances against computed royalties. The value of production for coal, oil, and gas and associated products in the draft regulations shall be the estimated reasonable value of the product as determined by the Associate Director of MMS. In establishing the value, the regulations will establish benchmarks based upon arms-length and non-arms-length contracts under criteria of:

1. The highest price paid for a part or for a majority of production of like quality in the same field (arms-length equivalent).
2. The price received by the lessee.
3. Posted prices.
4. Other relevant matters.

Note: Under no circumstances shall the value of production be less than the gross proceeds accruing to the lessee. Gross proceeds will establish the minimum royalty value.

Royalty rates are specified in the lease terms and will be applied against the product value in computing the royalty due.

Transportation and Processing Allowance

Costs allowed against royalties are for transportation from the lease to a sales point remote from the lease and for costs incurred in processing associated marketable products. Reasonable actual transportation costs shall be deductible in establishing value for royalty purposes. However, deductions cannot exceed 50 percent of the value of the product. Reasonable actual costs incurred in processing associated marketable products shall be allowed as long as total values are enhanced. Deduction for processing costs cannot exceed two-thirds of the value of the marketable products. The new draft regulations specify both transportation and processing allowances must be approved by MMS before the payor claims deductions against royalty owed.

In the past, deduction costs of two-thirds of the value for associated products have been allowed by the Department and the new draft regulations will continue that practice. Department officials advised that because of this policy, the RMP processing allowance has paid for most of the processing plants that process Federal and Indian natural gas. For example: a payor reported to MMS on Form 2014 a $6,990.57 royalty due on natural gas liquids; on the same form the payor took a $4,593.05 processing allowance credit. The net result was that the payor only paid a $2,296.52 royalty, but more importantly the payor was allowed to deduct $4,593.05 as a processing allowance. In the lease analyses it was found that this payor claimed NGL processing allowances of $14,686.12 for gas processed for four leases in September 1985 all of which was processed at a processing plant belonging to the payor.

Normal industry practice in processing natural gas and extracting the natural gas liquids for a producer depends upon the quality of the gas. For example, a sweet gas requires reducing the gas temperature to the point where the NGL's will condense and the processing plant probably would take about 20 percent of the NGL's and return 80 percent to the producer. Naturally, where the gas quality is poor; i.e., contains hygrogen sulfide, carbon dioxide, or other impurities which require additional processing, the plant operator would take more NGL's in payment.

A new concept has been added to the draft regulations which greatly confuses and complicates the processing allowance. In the past, processing allowances have been determined (and allowed) on a plant basis. In the new draft regulations allowance approval will be on an individual owner basis. This results in different allowances for each owner based on each owners costs. It is likely one owner will have a two-thirds allowance while another owner will have a one-fifth allowance. Then somehow this has to be allocated to the lessees. This new policy will result in new plant owners again having the RMP pay for their purchase of the plants. It also was suggested the policy will cause many purchases of processing plants.

MMS Has Not Collected Penalties

According to MMS officials penalty charges have never been collected from even one payor. Except for Marathon Oil Company, the letters sent payors covering assessment of criminal penalties for noncompliance have been responded to within the 20-day period given to remedy the violation. If a company acts on the violation within the 20-day period, no penalty is assessed. These notices (excluding Marathon Oil Company) were sent to payors signed by the Chief of MMS' Fiscal Accounting Division.

Marathon Oil Company was issued a Notice of Noncompliance, Penalty Notice, signed by the Director of MMS. The notice, dated September 29, 1984, stated that Marathon's willful and intentional disregard of the requirement to pay additional royalties, as specified in previous MMS orders, makes Marathon Oil Company liable for penalties of $10,000 per day for the seven leases in question--a total of $70,000 per day.

According to the OIG solicitor's office, the District Court ruled that Marathon Oil Company must pay $717,705 in royalty underpayments. However, as of January 15, 1986, the decision on the payment of the assessed penalty is pending before an administrative law judge.

The RCD presently has six cases whereby penalties should be assessed, and it is awaiting the decision of the Department of Interior to develop a position. Generally, a refusal to comply to an order, not providing access to records, or repetitive violations will result in penalties.

An area which is conspicuous by its absence and one of the primary reasons for the FOGRMA, that of non-reporting and underreporting, is not being considered by MMS as an area subject to penalty. The Investigative Staff was advised that MMS may add these to their penalty strategy.

Drainage Problem Has Been Exacerbated by Issuance of IM 85-289

Drainage is the migration of oil or gas in a reservoir owing to a pressure reduction caused by production from wells drilled into that same reservoir, e.g. if two companies each have a lease that would produce oil and gas from the same reservoir and only one company drills a producing well, the company who did not drill a well is having oil or gas drained from his share of the resource. BLM would notify the company who did not drill that he is required to drill an offset well in order to stop drainage from occurring. If the company chooses not to drill, BLM will assess compensatory royalties.

BLM officials advised that an aggressive drainage program is vital to insure that the Government is receiving all royalties due. The primary purpose of a drainage program is to convince the lessee to drill an offset well. When this prompting does not work, BLM could always fall back on compensatory royalties.

One of the most aggressive drainage programs in BLM was operated by the Albuquerque District Office. From 1981 through 1983, the most current period for which statistics are available, the District worked 350 drainage cases of which 25 resulted in compensatory royalty drainage assessments of $400,000. However, more importantly, 100 wells were drilled as a result of the aggressive "prompting" on the part of BLM officials. Based on BLM estimates, these 100 wells, over a 10-year period, will produce royalties of about $11 million. In the Albuquerque District, alone, about 450 additional potential drainage cases may exist.

To ascertain the extent of the drainage problem BLM contracted with Keplinger Technology Consultants, Inc. On September 1, 1985, the contractor reported that:

-- With several notable exceptions, the drainage program tends to be subordinated to "demand" workload.

-- There is an undefined backlog of drainage work in many offices, and in some instances this program does not appear to be diligently pursued.

-- There is a shortage of supervisory personnel handling the drainage program.

-- There is a perceived lack of career advancement opportunities for those personnel involved in drainage work.

-- The incidence of errors and omissions in the data base to prepare drainage work cases decreases drainage productivity.

-- The consultants encountered morale problems among the minerals professionals throughout the offices visited.

BLM has given a low commitment to the drainage program. For example, priority-wise, in New Mexico drainage only has a higher priority than other training. BLM nationwide on drainage problems for the first half of FY 1985 only expended 78 workmonths or about 1 percent of total workmonths expended. BLM, on January 18, 1985, advised the New Mexico State Director that a new policy on drainage would be forthcoming. This new policy was issued March 4, 1985, as Instruction Memorandum No. 85-289. It was determined that the primary impact was that drainage cases on all "older drainage problems" (over 1 year old) have been effectively eliminated. For example, the State of New Mexico, as of January 31, 1985, had reviewed 18 drainage cases; as of September 30, 1985, even though 6 cases per month were scheduled, not another drainage case was reviewed. The Investigative Staff was repeatedly advised that IM 85-289 has terminated a much needed program.

The State of Wyoming on July 16, 1985, advised the District Manager, Rawlins, that:

> "Based on the new guidelines it is doubtful too many of the older drainage cases dating back to the 1930 and 1940's can be pursued. The new guidelines should make it easier to clean up the backlog of older cases and then concentrate on new cases."

Since many advocates supporting the issuance of the IM could not be found, an attempt was made to ascertain its genesis. It was determined that an operator in New Mexico-referred to by BLM officials as "Uncle Al"--had for some time been trying to change the compensatory royalty rules as several of his Jicarilla leases were being assessed compensatory royalties.

On January 9, 1985, the operator flew to Washington to meet with the BLM Director. On January 15, 1985, as a followup to that meeting the operator wrote Albuquerque and stated that:

> "The meeting was held January 9, in Washington in the Assistant Secretary's office. * * * It was agreed at the meeting that BLM would again review its policy on this issue and that in the meantime, the Chief of Fluid Minerals was instructed to advise your office not to file an appealable decision in this case until such time as they have had an opportunity to review their policy as to "old" cases. * * *
>
> We presume that you now have been advised of this; but if not, we would appreciate your letting us know."

On January 18, 1985, the Chief of Fluid Minerals Operations was directed to write IM 85-289. Also, the Acting Director, BLM on the same date, advised the State Director, New Mexico, that:

> "In a recent meeting here with industry representatives from New Mexico and elsewhere, some concerns were expressed regarding the present requirements of the subject Manual Section in relation to the so-called "older cases," i.e., those potential drainage situations discovered by this Bureau more than a year after the onset of production from a possible offending well.
>
> "During the course of that conversation, it was suggested that another facet be considered in determining whether compensatory royalty should be assessed in these "older cases" where the drilling of a protective well at the present time would be an uneconomic venture. (Underscoring provided)

"* * * Once begun, we will expedite the final decision. Because our decision may be to revise the manual, we ask that, in the interim you issue no appealable decisions to lessees and operators concerning "older drainage cases."

It was determined that the previous drainage policy merely required a determination whether drainage was or was not occurring. This significant economic change "of requiring a determination as to whether or not a protective well at the present time would be an uneconomic venture" has all but eliminated compensatory royalty or the drilling of offset wells for older drainage cases.

The other instruction "of issuing no appealable decisions to lessees and operators of older drainage cases" also severely impacted on the drainage problems. Because of the IM the Albuquerque District Office placed in retirement the three drainage cases identified.

Based on the review of one of the operator's Jicarilla leases, it was found that this retirement may be erroneous. The Interior Board of Land Appeals advised that in those cases where the operator of the offending well is also the lessee of the offended lease, "fraudulent drainage" is occurring and compensatory royalties should be assessed. One of the operators leases falls within this category.

Impact on Wyoming

The BLM State Director in Wyoming advised that because of the IM eight drainage cases, with estimated compensatory royalties of about $370,000, have been closed and the monies were not deemed owed as of January 3, 1986. In one of the cases, lease W-30113, the offended lessee had negotiated the drainage percentage from 10 percent to 4.8 percent and offered to pay the Government $43,800. However, a BLM letter dated June 4, 1985, to MMS stated in part: "Due to recent policy changes the 4.8 percent compensatory royalty assessment has been rescinded."

Theft of Oil and Gas From Federal and Indian Leases Continues

During the Subcommittee's hearings on the Department's 1986 budget, the following exchange regarding oil theft took place:

Mr. Yates:	Is the inspection foolproof?
Mr. Burford:	I doubt that any inspection is foolproof.
Mr. Yates:	That is what I wanted to ask Mr. Jordan. You said you look at valves and meters. Is there any way of playing around with valves and meters?

Mr. Jordan: (New Mexico) We have never discovered a single case.

Mr. Yates: Nobody has ever raised that question?

Mr. Jordan: We have done thousands of inspections.

Mr. Yates: So if I understand what Mr. Burford and you are saying, it is that you don't have any cases of theft that you have come upon; that it really isn't a pressing matter then. Is this correct?

* * *

Mr. Latz: That is right. Literally tens of thousands of inspections and no uncovered theft.

* * *

Mr. Latz: No, I just said simply, Mr. Chairman, there have been 10,000 inspections and not a single instance of theft. How far can you extrapolate that? Still there might be one instance of theft.

During visits to the MMS and BLM offices in Albuquerque, New Mexico, an inquiry was made regarding theft of oil and gas. An MMS official advised that he receives reports of theft on a daily basis from the BLM Farmington Resource Office. The official provided several reports which he advised are merely filed. The BLM District Office official also acknowledged that theft in the Farmington Office was very common and stated that he has been monitoring the thefts since 1983. The thefts ranged from 40 gallons of condensate (high gravity oil) to several hundred barrels. The following schedule shows the number of thefts reported by the BLM office:

BLM
Reported Oil Thefts

Calander Year	Number of Reported Cases of Theft	Barrels Reported Stolen	Largest Single Reported Theft
1983	650 (est.)	10,282	544 barrels
1984	265	5,330	160 barrels
1985 (through November)	325	3,195	110 barrels

In many of the reported cases the number of barrels taken was not determined. In other words the reported number of barrels stolen is understated. The theft was merely reported to the cognizant BLM office as having occurred.

The BLM office receiving the report of theft would immediately record the theft and prepare and submit the report to the BLM Inspection and Enforcement Division in Washington. Other copies of the report went to the OIG in Lakewood, Colorado; BLM Albuquerque District Office; and FBI, in Farmington, New Mexico. Nine other organizations also were on the distribution listing.

The reasons for the theft cited on the reports were (1) unknown, (2) broken seal, (3) broken valve, (4) thief went through thief hatch, and (5) a truck was involved. In some cases the dollar value of the stolen condensate was also estimated such as 123 barrels with an estimated value of $3,444.00 or $28.00 per barrel. (See attachment)

The Headquarters Inspection and Enforcement Division was contacted and asked what it had done with the reports and if any other BLM office was reporting thefts. The officials advised that Farmington is the only office reporting theft to Headquarters and that they have been aware of the thefts and have attempted to begin a pilot project on theft at Farmington and the Wind River Reservation in Wyoming. They also stated that BLM did not have a strategy for theft nor how theft should be reported and investigated. The officials stated that they are currently working on guidelines for reporting thefts. The "draft" of these pilot project guidelines addresses the problem, but appears not to provide the necessary funding or staffing.

The BLM New Mexico State Office noted that in calendar year 1985 about 325 instances of theft were reported. The New Mexico response to the "draft" states:

> "The Special Agents in the affected States (New Mexico and Wyoming) already have full work load responsibilities, commitments, and priorities. To impose on the Special Agents the duties and responsibilities suggested by this Pilot Program without providing the tools and manpower to accomplish it suggests that this is either intended to be a token effort, or is intended to fail and become subject to severe criticism with a subsequent placing of blame on a "scape goat."

Oil Industry Concerned About Crude Oil Thefts

In a recent seminar the Petroleum Industry Security Council of Texas noted that for the last 3 1/2 years it has been intensely involved in the effort to combat crude oil theft. The Council has been able to examine the problem essentially on a national basis by working closely with oil companies and local, State, and Federal law enforcement agencies. From this work the Council has been able to came to the following conclusions:

- There are no meaningful statistics available with which to measure the crude oil theft problems;
- Crude oil theft is a crime that is seldom fully understood or even detected by the victim companies; and
- Crude oil theft is indeed a crime of significant proportions in the United States.

Unresolved Indian Royalty Problems

In addition to the serious problems yet to be resolved by MMS, BIA has their own management deficiencies which hinder the accurate and timely disbursement of oil and gas royalties. In a January 4, 1985, letter transmitting the comprehensive Interim Report on Oil and Gas Management to the Assistant Secretary, Indian Affairs, stated:

> "It cannot be overemphasized that serious management and operational deficiencies exist that will require resolute corrective actions be taken. In short, trust obligations, respective to Indian Oil and Gas Management, needs special attention and considerable improvement."

The interim report contained 35 recommendations, some of which reiterated problems cited in the Linowes Commission Report. The general observations of the report listed the following observations which should be addressed by the Department:

Fragmentation of Responsibilities:

> "At the present time, responsibilities for Indian oil and gas management are divided among three separate Bureaus * * *. The existing fragmentation [distributes] overall responsibilities among the BIA, the BLM, and the MMS [which] exacerbates the problems.* * *"

Management Priorities:

"The distribution of resources in Indian oil and gas management appear not to be focused upon effective management of the Indian resource.* * *"

Distribution of Financial and Human Resources:

"* * * most Indian oil and gas management matters are administered through the Bureau's Real Property Management branches at the Area and Agency levels. Staffing and funding for this program, let alone the providing of any specialized assistance, has been diminishing while additional legislation such as the Indian Land Consolidation Act or the Indian Mineral Development Act are increasing the workload.* * *"

Management Commitment:

"* * * that considering the importance of mineral lease management activity to the tribes and allottees as a source of continuing and increasing income, BIA management has been less than effective in forcing improvement of Indian lease management activities.* * *"

On January 21, 1986, the Assistant Secretary, Indian Affairs, advised that the above matters are either being studied or that corrective measures have already been implemented. He also advised that the Director of Trust Responsibilities would be the designated official responsible for the administration of oil and gas resources.

Blanchard Decision May Have Resulted in Substantial Losses to Oklahoma Indians

On October 22, 1963, the Oklahoma Supreme Court in the case of Shell Oil Co., et al. v. Corporation Commission of Oklahoma No. 39672 (commonly referred to as the "Blanchard Decision") held that all one-eighth royalty owners within a well spacing unit established by the State are entitled to a share, proportional to acreage owned in the unit, of one-eighth of all the spacing unit's production and proceeds. The effect of the Blanchard Decision has been to allocate production to acreage owned in the unit, regardless of the productivity, or nonproductivity, of each royalty owner's acreage.

By memorandum dated May 23, 1967, the Chief, Branch of Oil and Gas Operations of the U.S. Geological Survey, applied the Blanchard Decision to all Federal and Indian leases in Oklahoma. This application was particularly detrimental to the Indians because of the generally higher royalty rates associated with Indian lease agreements. In fact, opinions from the Department of Interior Solicitor's office dated June 29, 1966; July 19, 1966; and March 18, 1983, specifically state that without the Secretary of Interior's approval, no State law can overrule the Secretary's control over Federal and Indian mineral leases. Department officials advised that there are three major reasons why the Blanchard Decision should never have been applied to Federal and Indian leases in Oklahoma:

-- Apparently the Secretary of Interior never gave approval for use of the State court ruling.

-- The language of 30 CFR 221.47 unequivocally states that royalty shall not be computed upon a production value basis that is less than the gross proceeds accruing to the lessee for the sale of his gas.

-- The Government, as trustee, may not agree to accept less royalty than that to which the Indian is entitled under the governing lease and communitization agreement.

Finally, in November 1985, MMS issued a directive to the royalty payors that the Blanchard Decision would no longer be used for calculating and paying royalty on Federal and Indian leases in Oklahoma. This was effective beginning with November 1985 sales which were reported to MMS by December 31, 1985.

Even though the Blanchard Decision has now been recinded, the Indians were deprived of large amounts of money during the period it was in effect. This has been proven by audits, hearings, and court actions. For example, MMS auditors advised that every audit involving the Blanchard Decision found additional money owed to the Indians. It is difficult to understand why BIA, which has Indian trust responsibility, did not immediately advise the Secretary of the adverse effect of applying the Blanchard Decision to Indian leases in Oklahoma.

BIA Abrogates Wind River Lease Cancellation

In a matter related to the original royalty management problems of the early 1980's, an official advised that because of unreported royalties the Arapahoe and Shoshone tribes were negotiating with the operators of two leases for a settlement on unpaid royalties. The tribes had also initiated a cancellation petition in November 1981.

On January 13, 1986, the Assistant Secretary for Indian Affairs dismissed the cancellation petition and on February [illegible], 1986, the operators of the two leases withdrew their settlement offer.

UNITED STATES GOVERNMENT

Memorandum

DEPARTMENT OF THE INTERIOR
BUREAU OF LAND MANAGEMENT

IN REPLY REFER TO
3100 (016)

To : Inspection and Enforcement Division, MS-504, BLM Date:
Department of Interior, 20240 Attn: Gil Lockwood

From : Area Manager (NM-016)

Subject: Theft of Oil and Condensate From Federal and/or Indian Leases

By this memo you are advised of a theft of hydrocarbons that has occurred within the Farmington Resource Area, New Mexico. Details of the theft are noted below:

Operator American Pen Energy Lease No. NM-42428

Well No. Federal 1-19 Location NESW (1/4 1/4) sec. 19 T. 30N R. 15W P. M.

County San Juan State New Mexico Date Theft Discovered 2/15/85

Volume Lost 123 bbls Estimated Value 3,444 Oil ____ Condensate ✓

Reported By Charley Say Representing American Pen Energy

Remarks: Possibly a bob tail truck involved

Report Received By ____ Date 5/10/85

By copy of this memo the following agencies are notified of the above theft. All thefts of crude oil and condensate over 25 bbl have been reported to you by phone.

1. Office of Inspector General
   Investigation Division
   134 Union, Suite 510
   Lakewood, CO 80228

2. ✓ BLM, ADO (01537)
   Albuquerque, NM

3. FBI, P. O. Box 2100
   Farmington, NM

4. MMS, Royalty Management Porgram
   P. O. Box 5810
   Denver, CO 80217

5. Jicarilla Tribal Police
   Dulce, NM 87528

6. Jicarilla Tribal O&G
   Dulce, NM

7. Bureau of Indian Affairs
   Shiprock, NM (Navajo)
   Crownpoint, NM

8. Bureau of Indian Affairs
   Dulce, NM (Jicarilla)

9. New Mexico State Police
   1025 W. Navajo
   Farmington, NM

10. Navajo Police
    Shiprock, NM 87420

11. Navajo Area Office, Area Director
    P. O. Box M
    Window Rock, AZ 86515-0714

12. Office of Inspector General
    Investigation Division
    P. O. Box 1870
    Albuquerque, NM 87103

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THE SECRETARY OF THE INTERIOR
WASHINGTON

October 1,1986

Honorable Sidney R. Yates
Chairman, Subcommittee on Interior
and Related Agencies
Committee on Appropriations
House of Representatives
Washington, D.C. 20515

Dear Mr. Chairman:

I am in receipt of your letter of September 25, 1986, requesting that we provide a response to the preliminary report on royalty management matters by October 1. Because of the very substantial amount of work necessary to respond to the preliminary report, I have just today received responses from the Bureaus. While I have not had an opportunity to review them in any level of detail, I have discussed the nature of the responses with staff and am satisfied that the responses are appropriate. Since you have indicated a desire to receive these responses today in conjunction with releasing the preliminary report, I am hereby providing you with a copy of the responses from the Minerals Management Service, the Bureau of Land Management, and the Bureau of Indian Affairs.

Sincerely,

Donald Paul Hodel
DONALD PAUL HODEL

Enclosures

United States Department of the Interior

MINERALS MANAGEMENT SERVICE
WASHINGTON, DC 20240

OCT - 1 1986

Memorandum

To: Secretary

Through: Assistant Secretary - Land and Minerals

From: Director, Minerals Management Service

Subject: Response to Preliminary Report entitled "Royalty Management Program" Prepared by the Investigative Staff of the House Committee on Appropriations

The Minerals Management Service (MMS) has completed its review of the subject preliminary report which was provided to you in a September 11, 1986, letter from the Chairman, Subcommittee on Interior and Related Agencies, House Committee on Appropriations. I have attached two separate documents in response to the report and would request that you consider providing both to Chairman Yates as a part of your overall response.

The first of these documents is a detailed MMS commentary on the report itself. The second document entitled Review of a Preliminary Report entitled "Royalty Management Program, Department of Interior" provides a structured overview of the RMP and contains many additional observations and comments on the report, along with other factual information regarding the status and accomplishments of the Royalty Management Program (RMP). This second document was prepared to provide a context for understanding the many negative statements made in the report and provide information on the many obvious omissions and errors. Hopefully it will serve to educate the Committee and other readers about the royalty management process.

I also want to provide my overall comments and observations on the report. In many places, the report is factual; in many others, it is in error. In many cases, facts are misinterpreted and lead to erroneous conclusions. Some of the problems cited are related to the wrong cause. In others the authors simply misstate the facts in apparent confusion. The report generally lacks supporting facts, illustrations, and adequate explanation to provide context and balance. Finally, it contains no suggestions for improvement.

I see two areas of major concern in the report which deserve special mention. The first is an "indication" that a substantial amount (21 percent) of Federal and Indian lease royalties have not been detected or collected. The second is that the report fails to provide an accurate assessment of the progress made in royalty management, particularly in the last two years. Specific comments on these two areas follow:

Underpayment of Royalties

Based on information allegedly provided by MMS and four States, the report presents a table indicating that 21 percent of royalties due for a set of audited leases was underpayed. The report then leaps to the unsupportable conclusion that, "Applying the 21 percent of underpaid royalties to the $28 billion of royalties collected by the Department since 1979, indicates that as much as $5.8 billion in royalties may be underpaid by the holders of Federal and Indian oil and gas leases." This 21 percent projection in unpaid royalties is grossly inflated. Amounts used to calculate the 21 percent figure are not consistent with information available to MMS regarding the results of State audit efforts. We have attempted to obtain information from the four States cited. Three States claim no ownership of the information used in the report and we are awaiting response from the fourth. The statistics provided to the investigative staff by MMS were accompanied by a long list of caveats which would substantially affect any data projections or conclusions reached. Unfortunately, there is no reference to these caveats anywhere in the report. The more significant of these were:

- The amounts did not include those amounts of royalty paid on audited leases for which no royalty violations were found. This would substantially reduce the percentage calculated.

- Our auditors whenever possible have concentrated on the best audit targets and those audit results cannot be extrapolated to the universe of lease payments.

- Many of the audit findings were based on complex legal and interpretive issues which are on appeal or in litigation and which may be decided in favor of the payor.

- The audit collections or findings were for underpayments only, and did not include offsetting overpayments.

- Many of the audits covered periods back to 1978, well before improvements to the RMP were in place.

MMS has made no specific studies to ascertain what percentage of royalties might be underpaid. We question whether such determinations can be made with a reasonable degree of accuracy because of the difficulty in obtaining a representative sample and because of the substantial fluctuation in prices of leasable minerals over the past few years. The indications we have to date appear to be more in the range of 3 percent initial underpayment of total royalty receipts.

Even more importantly, we have acknowledged and have previously testified before the Subcommitte that royalty underpayments do exist. They will continue indefinitely to some extent. That is why we operate a major audit program and employ many other underpayment detection techniques. The following supporting RMP activities are fundamental to an ongoing effort by MMS to identify and collect underpaid royalties.

- Audits resulted in collection (or denial of refunds) of about $111 million in unpaid royalties during the first eleven months of Fiscal Year 1986, bringing total program collections to approximately $320 million.

- Automated exception processing was implemented on the Auditing and Financial System (AFS) in February 1985. Since that time over $10 million in interest (paid at the IRS penalty rate) has been collected on Federal and Indian leases. Bills for collection have been issued to payors for another $1.7 million as a result of erroneous reporting, late reporting, or failure to report.

- Additional revenues from Production Accounting have totalled about $8 million in the last year.

- MMS also recently implemented a comprehensive enforcement and penalty strategy to further promote and encourage prompt and accurate royalty reporting and payment. A total of 16 civil penalty notices have been issued to payors who failed to properly report and pay royalties due after due notice and time to correct identified problems.

- MMS has a number of cases in litigation involving disputes with payors over unpaid royalties and bills for collection. As you know, MMS has a highly successful litigation record thus far.

Failure to Recognize Progress Made

Additionally, the preliminary report does not present a balanced picture of the RMP and fails to recognize the progress made under the many initiatives recently implemented or in process. The Management Action Plan (MAP) for the RMP was issued in April 1985, enumerating over 40 actions designed to overcome known problems. Many of these problems are again resurfaced by the preliminary report. Over 50 percent of the MAP actions have been completed, and most of the remaining actions are nearing completion. We remain confident that the actions implemented or underway will resolve many of the problems that have been plaguing Royalty Management for at least two decades. Some of the more noteworthy of these actions are:

- The Royalty Management Advisory Committee, established late last year, has already provided valuable advice for several major RMP initiatives such as new product value regulations.

- As previously mentioned, audit findings continue to be significant with about $320 million in unpaid royalties collected since inception of the RMP in October, 1981.

- Royalty collections by States and tribes under delegated audits provided for in Sections 202 and 205 of the Federal Oil and Gas Royalty Management Act of 1982 (FOGRMA) have also been substantial with about $45 million in collections.

- A new RMP automated system, commonly referred to as STATSS, is now operational. It provides States, tribes, and other bureaus of the Department with direct access to the RMP accounting systems in Lakewood, Colorado. A total of 9 States, 9 tribes, and 4 Bureau of Indian Affairs field offices are already operational on the system.

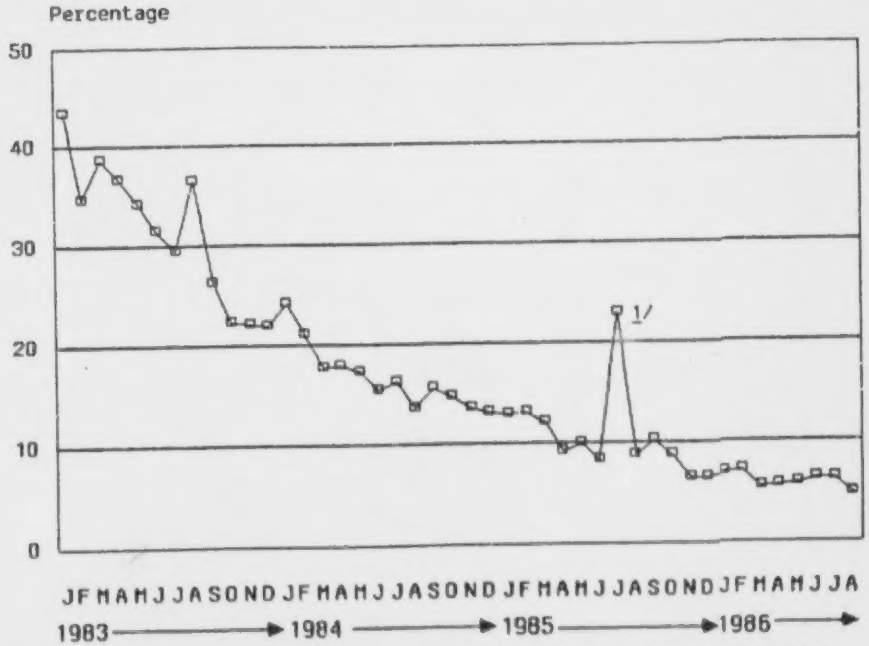
- The exception processing modules of the AFS have proven to be a valuable tool in the detection and collection of additional unpaid royalties as described previously.

- The RMP has made substantial progress in reducing the overall error rate of the AFS. Specialized training has been conducted for some 90 payors, and the data bases of another 36 payors have been reconciled in a special effort. All Federal leases have been reconciled and all Indian leases will be validated by the end of December 1986. These and other ongoing initiatives such as the new MMS enforcement strategy have brought the AFS System error rate to a recent all time low. I have attached for you the AFS error rate chart which shows a decline in the AFS error rate from over 40 percent in January 1983 to 4.8 percent in August. This reduction in error rates has truly been significant and has also resulted in expediting payments to States and tribes.

There is one additional area addressed in the report that I would like to bring to your attention. The report states that a misguided decision to develop the royalty collection systems on VAX minicomputers cost MMS about $50 million in contract costs. While we have been unable to validate the cited amount, it approximates the total development costs for AFS and the other two RMP systems, (PASS and BRASS), as well as the total operations and maintenance costs for all three systems dating back to Fiscal Year 1981. It is important to note that had the RMP Systems been originally designed on a mainframe computer instead of VAX minicomputers, the primary savings to the Government would have been $8.5 million in hardware and system conversion costs. Most of the other costs would have been incurred whether systems were developed on minicomputers or a mainframe computer.

AFS ERROR RATES

CALENDAR YEARS 1983, 1984, 1985, AND 1986 TO DATE



1/ Error rate increase is due to single payor's incorrect tape reporting of 34,806 adjustment lines with an incorrect two-digit code (of the month's total of 56,078 lines).

DETAILED COMMENTARY ON THE PRELIMINARY INVESTIGATIVE STAFF REPORT

The first four pages of the preliminary report cover some historical background about the royalty management program, computer hardware decisions made in 1981 and 1985 and their impacts, and some basic software design issues. Some of the points made in this segment of the report are valid, others inaccurate or misconstrued, and some confused. In other cases, a modest amount of additional information is useful in providing a better perspective for understanding the points being made.

To first summarize this segment of the report, the historic data on the first page and a half are largely correct but can use some amplification and minor corrections. The judgment that the minicomputer decision was a serious mistake is one which Minerals Management Service (MMS) officials have long agreed with and testified to. The sections on page 3 and 4 convey a largely incorrect understanding of the design of the "AFS" (Auditing and Financial Systems) system and its relationship to the minicomputer system and the "RAS" (Royalty Accounting System) system that was replaced by AFS. A detailed commentary follows.

Background (page 1)

This paragraph is accurate with the exception that the last sentence needs expansion. The Production Accounting and Auditing System (PAAS) is on line for all offshore oil and gas leases, all solid mineral leases, and approximately 1,300 of some 22,000 onshore oil and gas leases. Overall, the leases reporting to PAAS represent only about 17 percent of the total universe of producing leases but over 70 percent of that royalty revenue. A decision not to implement all onshore oil and gas leases on PAAS was made in the autumn of 1984. The decision was ratified in April 1985 and was publicly announced and subsequently testified to. The decision was made to wait until experience was gained in operating the system (which became operational in February 1984) and until a thorough feasibility study of its cost effectiveness was prepared. It was clear that implementation of production reporting on PAAS for the remaining leases would be difficult and expensive for both the Government and industry and potential benefits had not been quantified. The portion of the leases implemented thus far on PAAS has been the easiest part of the implementation because of an existing and largely adequate and correct data base existing for offshore leases.

The PAAS onshore study is nearing completion. A panel of the Royalty Management Advisory Committee is also examining PAAS alternatives. The full Committee is scheduled to review this work and make recommendations to the Secretary in October 1986. In the interim, production data for other onshore leases continue to be reported to the Bureau of Land Management (BLM).

Royalty Management Program (page 1)

Paragraph one of this section is accurate. It is useful to point out, however, that: (a) responses have been prepared (and, typically, submitted to Congress) on these reports, (b) many of the suggestions made in these reports have been implemented and others are being implemented, (c) other deficiencies have been addressed or are being addressed, and (d) some of the suggestions turned out to not be good ones and some criticisms missed the mark. It would have been useful to the reader for this report to have covered these points so readers could better evaluate the health and progress of the Royalty Management Program (RMP).

The second and third paragraphs are essentially accurate. By way of explanation of the final sentence, Arthur Anderson was directed to leave the facility since the design contracted for was complete. The actual design was contracted to Sterling Systems, Inc., an 8(a) firm, on the basis that a major accounting firm would be hired by Sterling to do the basic design work. Criticisms had been raised about the lack of competition in the initial award and a decision was made that the multi-million dollar implementation and operation and maintenance contract should be competitively advertised and awarded.

Decision to Utilize a Mini-computer Rather Than a Mainframe (page 2)

The conclusion of the first paragraph is one that the Department agrees with, has testified to and is seeking to correct through the AFS conversion contract with Martin Marietta Data Systems (MMDS). We are unaware of what the reference to new leadership within U.S. Geological Survey (USGS) in April 1981, refers to. The USGS had an acting director at that time but the decision was made below that level in the organization. Our understanding is that that decision was made because of the unavailability of computer time on a USGS mainframe, because of the long contracting and budgeting period required to obtain a mainframe compared to the ease and low cost of minicomputers, and the view that the job could be done adequately on minicomputers. The latter judgment was erroneous and has been the source of great difficulty since.

The second paragraph appears accurate. Knowing that it was only an interim solution and a mainframe would be required, additional minicomputers were purchased in 1982 to run AFS. It was not completely appreciated at the time how difficult running AFS on minicomputers would be.

The final paragraph in this section is largely correct, but fails to recognize that the new RMP systems were subjected to constant changes not foreseen by the designers. In January 1983, the month before the AFS was to be dedicated, the President signed the Federal Oil and Gas Royalty Management Act of 1982 (FOGRMA) which made a significant change in how royalties were accounted for and disbursed to States and others. For example, royalty disbursements to States shifted from a semiannual to a monthly basis. Furthermore, the systems were required to provide detailed information to the States and Indians regarding their payments including late payments. These and other major modifications, in addition to workloads mandated after the systems had been designed, resulted in a requirement to operate the AFS on three VAX minicomputers instead of one as originally thought.

Based on a decision by the Department's Minerals Management Board in July 1982, the RMP undertook final system design of a second system (PAAS) necessitating the acquisition of yet another VAX minicomputer. Lastly, in December of 1982, Secretary Watt signed Secretarial Order 3087 which transferred accounting for bonuses and rentals for nonproducing leases from BLM to MMS. This resulted in the acquisition of a fifth VAX minicomputer. It should be pointed out that the $50 million figure cited in the report includes not only the implementation of the AFS, but also PAAS and the Bonus and Rental Accounting Support System (BRASS) (both of which work well), as well as their operations and maintenance costs for the period dating back to Fiscal Year 1981. Had the RMP systems been originally designed on a mainframe computer instead of VAX minicomputers, the primary cost savings to the government would have been $4.3 million for VAX hardware and $4.2 million for conversion, a total of $8.5 million. Most of the other costs would have been incurred in either case.

The point about diverting management talent from refining the system to merely making a bad system operate understates the situation existing in 1983 and 1984 and to a substantial extent yet today. It has drained management and staff talent not only away from systems refinements but also has slowed progress on a variety of other aspects of royalty management.

Planning Began for System X (page 2)

By the fall of 1982 it was apparent that the acquisition of additional VAX minicomputers would never solve the problem because of their inability to be tied together, and the tremendous overhead required by the installation of special utility software. Sensing the problem could only get worse, program management recommended in December 1982, even before the AFS became operational on the VAX, a competitive request for proposal (RFP) for leasing or acquiring a large mainframe computer which would meet existing and future needs. The RFP was issued in the fall of 1983 after clearances by the Department and GSA; proposals were received at the end of 1984; and a contract was awarded to Martin Marietta Data Systems (MMDS) in April, 1985.

The first paragraph is accurate, but it should be noted that the $80 million figure covers development and operation and maintenance of three systems operated on VAX minicomputers from 1981 as well as conversion, enhancement and operation and maintenance related to the mainframe operation through Fiscal Year 1987.

In the second paragraph it is further asserted that the conversion of AFS to the new computer had been delayed because the contractor found the MMS data base to be in more disarray than anticipated. MMDS has delayed its delivery schedule twice, and missed its most recent conversion target date of September 15, 1986. In October 1985, MMDS informed the Government of the delay in the date of delivery from December 1985 to May 1986. This delay was attributable to slow project start up by MMDS, delay in bringing key technical personnel on board, especially with regard to VAX operations, difficulty in planning the conversion effort, difficulty in developing and executing testing procedures and controls, and inability to use automated test tools, especially on VAX.

In May 1986, MMDS informed the Government of the second delay to July 1986 and then subsequently to mid-September. These delays are primarily attributed to MMDS difficulty with conversion of work packages, financial update subroutines, and on-line document application programs. MMDS also had extensive problems in the planning and execution of unit tests, reimplemented software, and the subsequent integration of the individual programs to meaningful subsystems. MMDS had to repeatedly rerun tests on the VAX to establish expected results for comparison to the IBM results. Integration testing was significantly extended because of previously undetected conversion errors.

Further slippage has now occurred as a result of additional time needed by MMDS to correct identified software errors and to conduct an adequate system test. Through the initial phases of system testing, MMDS has identified about 90 problems, most of which are errors in converted code. On September 8, 1986, MMDS verbally notified MMS that based on further technical evaluation, they had decided to expand their system test to a mutually agreeable level. MMDS, however, has not officially confirmed its revised testing methodology, nor has it provided the Government with a new AFS conversion completion date.

Effective September 28, 1985, MMS commenced assessment of liquidated damages in excess of $5,000 per day due to MMDS's failure to deliver the reimplemented AFS for government testing. The maximum liquidated damages allowed under the contract ($979,499) has been assessed.

System X Alone Will Not Solve All of the Problems (page 3)

The first paragraph states accurately that MMS officials do not consider the AFS conversion to the mainframe to be panacea. However, they do believe it will be a major improvement. In addition to capacity and speed, major benefits are expected in terms of on-line terminal access to make data corrections, the ease with which enhancements can be programmed, and the ease with which data can be retrieved and special reports prepared. Evidence of these latter points is available in the manner and speed in which the State and Tribal Support System (STATSS) has been designed and implemented to provide terminal access and data manipulation capability to States and tribes.

The reference to flawed data needs to be taken in context. The AFS lease data base was initiated using the data in the former RAS as it existed at the time of conversion--be that good or bad. A major effort has been underway--described later in this set of papers--to improve the accuracy of the data in the system. For the key data elements, that work is nearing completion.

In regard to the second paragraph, the information was not provided because it does not yet exist. The most important improvements have been identified and MMDS has begun work on some of them. The cost of these enhancements will not be known until MMDS has prepared design documents, implementation schedules, and associated costs. Many other suggested improvements will need to be evaluated by MMS and costed out--especially as experience is gained in running AFS on a mainframe after conversion.

We are aware of only three provisions of FOGRMA that require improvement of the AFS. The first is improvement in the accuracy of the unit price and royalty rate reported by industry and shown on the Explanation of Payments (EOP) report (this is available now on STATSS and on the original lease form). The second is improvement in the manner in which late payment interest to the States and Indians is calculated since this was a requirement added after implementation of AFS and could not be added to the system in an optimum manner. The other information necessary for compliance with the reporting requirements of FOGRMA is production data. The AFS receives and processes reports on sales data (on which royalties are based), but production data must come from a different source--PAAS or BLM. That is the subject of the PAAS study previously noted.

Designation of Mini-computer Created Design Problems (page 3)

The first part of the first paragraph is accurate. The minicomputer design definitely resulted in data base and operational problems. This has long been described as a problem to Congress and to representatives of States, Tribes, and industry. The remaining part, however, confuses the software design with the minicomputer operation. First, the data required are appropriate for auditing and fiscal accountability--to be supplemented by production data from a different system, and by company records and other documents through manual audits. The point on meeting legal requirements for information to States and tribes is a matter of systems design and was discussed above. The requirements did not exist when AFS was designed and being implemented. This is unrelated to the minicomputer decision, except to the extent that changes to the original systems design are much more difficult to make for the minicomputer operation. The data required for the three systems, however, do allow for auditing and fiscal accountability.

The original design of the AFS was based on the concept that reported data would be accepted and corrected subject to audit. MMS is aware that royalties are underpaid as evidenced by some $320 million in audit collections to date. Data contained in the AFS, i.e., amounts reported and paid, are used by auditors to compare with the official records of payors. Special as well as routine processing and reports from the AFS can be used to identify and select audit candidates. An example of special processing is the recently initiated extraction of recoupments by lease and payor. The AFS/PAAS is regular processing function that identifies anomalies in production and sales that can be referred for audit. Fiscal accountability is provided for in the AFS through a set of internal accounting controls developed by Price Waterhouse and Company, a subcontractor to the AFS system developer.

Inadequate and Inaccurate Data Bases (pages 3-5)

The AFS was, indeed, a radical change from the previous RAS. Such a change was necessary to overcome the many shortcomings of the RAS which seriously hampered the royalty management process. Examples of RAS shortcomings included its poor internal accounting controls, limited editing, data validation and compilation features, archaic and inflexible data base design and applications software equipment.

The impact descriptions in the report at the bottom of page 3 and top of page 4, however, are inaccurate and confused.

The draft report characterizes the AFS implementation as representing a "Conceptual change with reporting and royalty payments on a 'payor' basis," and that "This has resulted in loss of lease identity." The assertion that a loss of lease identity has occurred is simply untrue. This characterization is accurate only in the narrow sense that the AFS introduced general ledger revenue control features (double entry accounting), not present in the old RAS system, which focus at the payor level regarding the status of overall royalty payment obligations. The assertion that a loss of lease identity has occurred is simply untrue.

Accounting for royalty revenue under the AFS is based on the Accounting Identification Number (AID). The AID establishes accountability based on the source of revenue from which royalties are paid to the MMS. The highest level of reporting under the AID concept is the lease level, but, in most cases, the reporting occurs at the sub-lease level. In some cases the AID represents revenue from one well, but usually it represents revenue associated with a group of wells. In all cases, royalty information correctly reported on the MMS-2014 is immediately identifiable with and can be aggregated at the Federal or Indian lease level.

The AID reporting concept generally parallels the division order basis of revenue accounting used by the oil and gas industry. Industry has generally found the AID reporting concept to be compatible with their own accounting systems used to distribute production revenues to those parties involved in a well or wells, including the royalty owner. Likewise, MMS has found the AID reporting concept under the AFS fully adequate to successfully manage revenue payments from Federal and Indian minerals leases.

The draft report further asserts that, with the AFS implementation, "Changing all reporting forms for collecting data has resulted in the lack of a relationship to previous data collection instruments." In fact, one royalty reporting form (MMS Form 2014) was developed to replace three forms (Standard Forms 9-361, 9-153, and 9-614-A) used in the RAS. Contrary to the draft report's statement, virtually all data elements included on the three RAS reporting forms are contained on the MMS 2014 plus additional data elements necessary to support new internal control features of the AFS, such as the Systems General Ledger. Furthermore, instructions necessary for reporting adjustments to RAS-period royalty transactions on the AFS reporting form are provided in the MMS Payor Handbook, and thus demonstrate the relationship between the data collection instruments.

Changing the AFS system from a single mainframe computer to multiple minicomputers did not result in a complete redesign of the system and data bases. To the contrary, relatively few AFS programs had to incur changes due to the computer change. Particular programs now had to be selectively run on the correct minicomputer. The AFS data base remained the same although copied across multiple machines. Additional programs to transfer and resynchronize data between the multiple minicomputers did have to be added to the system.

Although little redesign was necessary to put AFS on the multiple minicomputers, a considerable amount of redesign effort was necessary to meet the expanded requirements of FOGRMA. While these changes had a significant impact on operations, the AFS was not completely redesigned and data collected and disseminated is identical to the original system design concept.

It is important to note that the single data base for AFS did not become a multiple data base system with the implementation of the minicomputer systems. AFS was implemented with a single data base. It was only after evaluating the combination of the additional FOGRMA requirements and the inadequate capacity of the VAX minicomputers in early 1983 that MMS management made the decision to copy the AFS data base across multiple machines. It was clearly unwise at that point to combine the PAAS and the BRASS data bases with the AFS due to capacity constraints.

The following paragraph referring to complete changes in concept, computers, and reporting normally never being implemented simultaneously is philosophically correct. We agree with the report that this was not a normal situation with the luxury of time to use a "normal" sequence. What was concluded in the late 1970's and endorsed by the Linowes Commission was that a different accounting concept using more data was required. This necessitated the acquisition of new computer hardware. It is not at all clear what the word "exacerbation" is intended to mean.

The following paragraph is accurate. The underscoring in the paragraph appears to be there for emphasis, but no conclusion is drawn. Sales of production from a lease are complex. A lease can have many products (for instance, natural gas, oil, butane, isobutane, propane, etc.) sold to a variety of buyers for a variety of prices each month by a variety of lease owners. The system simply reflects those factors. Product, price, quantity, and identification of the payor for each lease is central to such a reporting system. It is incumbent on the authors to provide arguments to the contrary if they conclude few lines of data will suffice.

The next paragraph describes the fact that the data base is replicated in three computers because of the minicomputer decision. That is accurate, and is one of the things the conversion contract is designed to cure.

The final paragraph appears factual. It is not clear, however, that conversion of EL Paso Natural Gas payments to AFS is worth the cost. MMS estimates that conversion would increase reported lines by as much as 50 percent for less than 2 percent of royalty revenue. El Paso has a particularly good royalty system of its own which pays on behalf of many payors lessees and working interest owners. MMS maintains an onsite team of auditors at El Paso which as a part of its resident audit program is to assure proper reporting. This arrangement appears satisfactory.

Reference Data Base Errors Adversely Impact on RMP (pages 5-7)

The report is correct in noting that one of the two major categories of data being entered into the AFS is "reference data." These are basic data about payors and leases, such as lease number, lease acreage, products, selling arrangements, etc. These data are important to the proper operation of the AFS, in part because, to a greater degree than any predecessor system, the AFS attempts to ensure the accuracy of monthly transaction data (the other major category of input data) by comparing certain data elements to those contained in the reference data base. The report is also correct in noting that, because of the complex and dynamic nature of the oil and gas industry, approximately 30 percent of the data in the reference data base is changed annually.

When the AFS was initially implemented, time did not allow the extensive validation and reconciliation of similar automated and manual data bases that had been maintained by the USGS, BLM, and the Bureau of Indian Affairs (BIA). However, an extensive effort to clean up elements of the reference data base important to ensuring the accurate collection and disbursement of royalties and rentals was initiated in January 1985 and is now being completed.

One part of this effort was the lease reconciliation project which was undertaken to ensure that all Federal and Indian leases are properly established on MMS's accounting systems. This effort has involved MMS, BLM, and BIA staff, as well as representatives from States and Indian Tribes whose efforts were funded by MMS under the Intergovernmental Personnel Act. The Federal lease reconciliation effort was completed in April 1986 with the result that 66 producing or producible leases were added to AFS (0.2 percent of all Federal leases on AFS), and 345 nonproducing leases were added to BRASS (0.4 percent of Federal leases on BRASS). While the identification of even one missing lease is important in ensuring that the Federal Government is receiving the revenue it is due, these numbers are far smaller than had been charged by some as recently as 1984. The effort to completely reconcile all Indian leases is currently scheduled for completion by December 31, 1986. Validation of AFS fund codes for all Federal leases was also recently completed.

Several steps are being taken to ensure that lease records are accurately maintained now that they have been reviewed. One of the most important of these steps is known as the Interagency Database Verification System (IDVS), an automated comparison of lease records contained in BLM's Case Recordation System with those in AFS and BRASS. This effort began in May 1986, and identifies leases which are listed on one system but not another, the dates on which the leases were issued, whether the lease is in a producing status, and the location of the lease. Each BLM State office verifies, once each quarter, the activity for the preceding quarter. This system should reduce substantially the number of data base errors for both agencies, and help to overcome the types of problems that can arise when responsibilities for lease management are divided (or "fragmented" to quote the report) among different agencies with separate data processing systems.

The report on pages 5-6 and 39-40 discusses the fragmentation of various mineral lease, operations and accounting responsibilities between the BIA, the BLM, and the MMS. The Department and the managers of the involved bureaus have long since recognized the risks of having these various responsibilities spread across the three bureaus.

Because it will always be necessary for the RMP to closely coordinate its activities with its counterparts in the other bureaus and because the others have a multitude of other responsibilities it has been decided to not reorganize and rather to establish mechanisms to assure that proper coordination of activities occurs.

The MMS's RMP has entered into Memoranda of Understanding with both the BLM and BIA to address the proper and necessary coordination of responsibilities. The BLM agreement has been in place for three years and the BIA agreement for about one year.

Each agreement estabished a steering committee. They meet periodically, usually quarterly, to discuss coordination, exchange of information, and other common concerns.

Examples of benefits achieved through these coordination mechanisms are:

- significantly improved communications and avenues for followup on common program issues;

- established a forum to clearly define roles and responsibilities so unnecessary duplication could be avoided;

- the Indian Lease Audit Strategy was cooperatively developed and implemented by the BIA/MMS Joint Steering Committee;

- MMS's receipt of necessary lease and related documents such as first production notices is now timely and an automated exchange of this information is now being developed;

- overall exchange of information, such as sales data needed by BIA and BLM is satisfactory; and

- disbursement of Indian royalties to BIA for distribution to Indian allottees is improved.

The report inaccurately implies that MMS must calculate the royalty rate paid on leases because it is unable to use the royalty rates contained in the AFS. The MMS has used a calculated royalty rate on the Explanation of Payments reports to the States and Indian tribes because it was believed that a calculated rate would more accurately explain what was reported by the payor. The MMS has since improved the reporting of royalty rate information through STATSS.

Monthly transaction data is checked, or "edited," to assist in assuring that the financial data being entered into the AFS is correct. As stated in the report, these edits lead to some lines being rejected until the cause of a "fatal error" can be determined and corrected. However, as a result of erroneous reporting assessments, the error rate has fallen substantially and more or less continuously since the AFS was brought on line. In early 1984, the error rate was around 20 percent but falling. In August 1986, this error rate fell below 5 percent for the first time, a level that has been considered to be the ultimate system goal. And while it is true, as the report states, that 40 to 50 percent of the errors were related to the data base, it is important to note that this error rate represents less than 3 percent of all incoming royalty lines rejected because of data base problems. One result of the dropping error rate is that, during the first 6 months of 1986, an average of just under 13,000 lines were rejected each month (out of an average of 207,000 lines processed) or about 35 percent less than the figure quoted in the report.

The report incorrectly states that MMS takes no action on warning errors. Warning errors do not negatively affect the primary function of AFS, but rather enhance the quality of the data received from payors. MMS regularly reviews warning errors and determines any need for upgrading. In the past, MMS has changed several warning errors to fatal. Before errors are upgraded, impacts on the error rate, workload, and AFS processing are carefully considered.

The report asserts that exception processing, assessing penalties, identifying candidates for audit, initiating bills, and collecting monies owed are not being done, MMS has and continues to perform work in all of these areas as detailed throughout this response.

Other Deficiencies Affecting Federal and Indian Leases (page 7)

The report states that the AFS does not handle penalties, joint ventures, recoupments, and royalty rates (Blanchard Decision leases). This statement is incorrect. MMS has implemented an enforcement strategy with provisions for penalty assessment which includes all leases. MMS also receives reporting information on royalty recoupments which are verified as a part of audits conducted by the MMS audit division. We have provided comments regarding the Blanchard Decision in a later section of this response. Nonstandard Indian leases, including joint ventures, are being subjected to special audits. The report is factually correct in stating that certain reference data elements for the above items are not currently maintained in the AFS. It is important to note, however, that many of these elements cannot be automated within the revenue concept of the AFS. It may not be necessary to automate others as accountability can be provided through specially directed audit.

Adjustments Complicate a Complicated System (pages 7-8)

The AFS was designed to accept adjustments to prior period transactions in recognition of regulatory and legal requirements and long established practices within the oil and gas industry. Adjustments to a payor's prior period reports result from court orders; determinations by government agencies such as the Federal Energy Regulatory Commission, BLM, and MMS; and information received from operators, purchasers, processors and transporters long after the product is sold. Analyses performed by MMS show that 65 percent of adjustment lines take place more than 6 months after the product is sold. The same analyses show that the net impact of these adjustments is a significant increase in royalties paid and, in most cases, interest on late payments. For example, a recent analysis of 90,000 volume adjustment lines, both positive and negative processed during the six months ended July 1986 resulted in net additional royalties of $24.7 million.

Adjustments entered into the AFS are subject to the same edits as other royalty lines. Furthermore, adjustments to royalties are routinely investigated during lease audits. It should be noted that if an audit reveals that a payor incorrectly or inaccurately uses adjustments, the payor will be required to refund royalties due and will be charged interest for late payments at the Internal Revenue Service (IRS) penalty rate.

The report notes that the total adjustments made in Fiscal Year 1985 exceeded net royalty collections. This is due in part, as explained above, to the complex nature of financial transactions in the oil and gas business. It is also because the total adjustments number cited in the report is a gross number consisting of positive dollars and negative dollars.

The draft report correctly describes the fact that MMS currently requires payors reporting adjustments on MMS Form-2014 to reverse an original transaction line reported in error and enter the correct transaction line. However, the suggestion in the report that no reason exists for this requirement is not correct. In addition to the AFS, this reporting requirement for adjustments also existed for over 20 years in the RAS. Continuance of the requirement in the AFS was determined necessary for proper internal accounting control of transactions and associated revenue and full disclosure for audit tracking purposes. This requirement was included as an element by Price, Waterhouse, and Company in their development of the accounting and internal control standards for the AFS.

From an internal accounting control and data base maintenance standpoint, it is critical to assure that any adjustment transaction and associated revenue change be identified to an original transaction and associated revenue paid. By requiring the identification of the original entry subject to adjustment, a determination can be made that an original entry in fact was made and paid by the current payor or a predecessor payor. Otherwise no information avenue would be available to validate that an original payment had been made. From an audit standpoint, the current requirement leaves a clear information trail to efficiently and effectively review the accuracy of royalty payments. Without this information trail, the auditor would be required to manually reconstruct payor transactions supporting net entry adjustments. Furthermore, without the current requirement, payors may not maintain supporting accounting information necessary to even manually reconstruct the payor transactions.

The results of submitting four "bogus" or fictitious MMS-2014's are incorrectly summarized in the report. Three of the reports were rejected by the AFS. The fourth cleared without error; however, the fact is that it was bogus was discovered in subsequent conversations with the payor.

MMS is deeply disappointed in the way in which the Investigative Staff conducted this test. These four reports are the only known fraudulent reports ever submitted to AFS. At least 10 MMS staff hours were expended in tracking and responding to the false reports. MMS was also placed in an embarrassing position with the companies and States involved. If other less risky alternatives had not been available, the Staff's approach might have been slightly more conscionable. However, MMS maintains a test data base which is made available to external audit groups to use in such experiments. MMS believes it is a credit to the system that the false reports were detected. Since the false reporting was a violation of Section 109(d) of FOGRMA, the MMS report on the incident was submitted to the Justice Department for review. A copy of that report is attached.

Untimely Resolution of Rejected Royalty Lines (pages 8-10)

Once a line is rejected, it is manually processed to determine the type of error and to identify the steps necessary to ensure its correction. Most errors are corrected during the month they are identified and in time to allow payment to the appropriate State, Indian lessee or the Federal Treasury. By July 31, 1986, the number of rejected lines at month's end had fallen to about 7,400, or 46 percent less than the figure quoted in the report. Rejected lines are prioritized for correction by their dollar value, not their age. Consequently, as shown in the table on page 9 of the report, while some lines may be more than 90 days old, their dollar value is relatively low.

To imply that all dollars associated with rejected lines are monies waiting to be distributed is inaccurate. As the report points out, the majority of the dollars in suspense are from offshore leases. Offshore monies, with the exception of 8g leases, are not shared with States or Indians. Also, the gross amount of money in suspense identified in the report is distorted. To maintain an audit trail, MMS requires payors to make adjustments by entering a negative entry corresponding to the original positive entry on their royalty reports. The majority of rejected dollars identified by the investigative staff are offset by these negative entries. The net result is that money is not owed either to MMS or to the lessee.

Most of the rejected dollars associated with Indian leases, as shown in the table on page 10 of the report, could not be distributed because MMS was awaiting approval of lease agreements or first production notices. Agreements awaiting tribal approval alone accounted for a suspended amount of $450,000.

System Output (pages 10-11)

MMS fully admits that the AFS currently does have problems that need correction. We have been clear on this point with Congress and with the States and Indian tribes. However, as already discussed, these problems are previously the result of implementing the system on minicomputers and changes necessitated by FOGRMA. Explanation of Payments (EOP), while certainly in need of improvement, currently provide highly beneficial data to the States and Indian Tribes showing the industry-reported basis for monthly disbursements. It must be remembered that the requirement for EOP's was established by FOGRMA, which became law after AFS reporting requirements had already been set. Sales quantity data is reported to BIA as well as the States. Production data, however, is not currently available for EOP's as no automated system has been implemented onshore for most onshore leases. Royalty rate is also reported to both the States and Indian Tribes as it is implicitly reported to the Department by royalty payments. The completion of AFS conversion to the mainframe environment will permit the Department to move ahead with planned EOP enhancements and additional types levels of exception processing to better assure the reported values are correct.

A decision was made in early 1985 to freeze the system design as it then existed until after it had been converted to the new mainframe computer. The continued delays in completing this conversion effort have delayed enhancements to the system and frustrated system users both within and outside of MMS. The report is incorrect, however, in implying that the current AFS falls far short of complying with legislative mandates and providing basic information necessary to the successful operation of the Royalty Management Program. Operations on the current minicomputers have become far more routine in the last 18 months. Approximately 95 percent of all monies due States and tribes are paid out within the month following receipt of sales reports.

The development of STATSS has provided some relief while awaiting the completion of the conversion effort. STATSS currently enables the user to make reference data base inquiries and to request any financial data contained in the AFS. This system first became operational in May 1986, and is currently installed in 9 states, 9 tribal offices, and 4 BIA area offices. An enhanced version of STATSS, scheduled for release in October 1986, will allow State or Tribal users to reconcile the disbursements they have received with the MMS-2014 lines reported by payors, and to see the reason why the monies associated with specific rejected lines have not been paid. We believe this initiative clearly demonstrates our resolve to comply with the spirit of the legislative mandates and meet the needs of States and Tribes.

The MMS Honor System is Ineffective (pages 11-13)

The report of the Investigative Staff states that the difference between the MMS and the IRS system is that the MMS lacks the ability to identify those payors who should be subject to audit. This is untrue. It is true that the computer will not automatically identify an underpayment when it is made; but there will never be a computer that can make such identification. The AFS will identify late reporting and nonreporting of royalties. Regarding underpayments, MMS has set up systems which will identify potential occurrences and help target companies or leases for audit.

The MMS has resident audit teams at the accounting offices of the 13 largest royalty payors. These teams audit both specific leases and the overall company production accounting, revenue accounting and royalty payment systems. Similarly, company audits for non-residency payors include reviews and testing of the same royalty related systems to determine if there are systemic problems. If systemic problems which impact royalty payments are found, the company is ordered to correct its system and to recalculate and pay any additional royalties that were underpaid.

Audit referrals are identified as a result of the AFS and PAAS comparisons of sales and production data. The PAAS is fully implemented for all offshore leases, all solid mineral leases, and a pilot group of onshore oil and gas leases. The Department and the Royalty Management Advisory Committee are currently studying the extent to which onshore oil and gas leases should be included in the PAAS.

The MMS also targets payors or leases for audit as a result of referrals from BIA, BLM, and the Inspector General and from the results of previous MMS or State audits.

The report of the Investigative Staff states that the IRS immediately imposes interest and penalty charges and that MMS has just recently begun imposing charges for late payment and is still studying penalty assessments. Actually, the MMS (and its predecessor agency) has been charging interest on late payments for offshore leases since 1979 when applicable interest regulations were adopted and since March 1, 1981, on late payments for onshore leases when applicable interest regulations were adopted. It was in February 1985 that MMS commenced immediate assessment of interest on computer-detected late payments. In addition to reporting assessments, MMS is also imposing civil penalties for noncompliance with MMS orders. The MMS has issued 16 notices of noncompliance. Nine companies complied after receiving notice, two companies paid $8,610 in penalties for nonpayment of $1,480 in royalties, penalties are accruing at $5,000 per day on three companies, and one penalty of $20,440,000 is pending on appeal before the Interior Board of Land Appeals.

Substantial Amounts of Oil and Gas Royalties May be Underpaid (pages 13-14)

Pages 13 and 14 of the report contain information indicating that 21 percent of royalties due go unpaid. MMS acknowledges that there are royalty underpayments and anticipates that this situation will, to some extent, continue indefinitely. That is why we operate a major audit program and have other underpayment detection techniques. Based on our experience to date, we believe that the vast majority of underpayments result from honest differences of opinion regarding what is owed, primarily due to differing valuation interpretations and from outright mistakes on the part of industry, not from intentional efforts to deceive as the report implies in a number of places. The existence of such underpayments is the primary justification for the aggressive audit program initiated in 1981 and other enforcement measures taken more recently to help assure that royalties are paid accurately and on time.

Various groups including Congressional subcommittees, the General Accounting Office, and the Linowes Commission have attempted to estimate the amount or percentage of underpaid royalties. MMS has not mounted a major effort to derive an estimate of unreported royalties, nor do we believe that it can be done with a satisfactory degree of reliability. Fluid prices and market conditions combined with continuous changes in the regulatory and enforcement climate make it difficult to arrive at a reliable assessment of underpayments during any prior period; these and other changes would make it even more impractical to project those results to the current period.

MMS has been unable to analyze the audit data provided to the Investigative Staff by State auditors. However, the amounts shown in the report are not consistent with information available to us regarding the results of State audit efforts. Since receiving the draft report, we have attempted to obtain from the States the backup information provided to the Investigative Staff. So far, three of the States claim no ownership for the information in the report. We will continue to pursue this information for review.

We recognize the data shown on page 14 as coming from an MMS Regional Compliance Office. However, when these data were provided to the Investigative Staff they were accompanied by a long list of caveats which should have affected the way these data were analyzed and used. These included the following:

- o The figures did not include the amounts of royalty paid on audited leases for which no royalty violations were found. This would have substantially reduced the percentages calculated.
- o Many of the potential findings were based on complex legal and interpretive issues that, on appeal, may be decided in favor of the payor.
- o The audit collections/findings were underpayments only, and did not include offsetting overpayments.
- o Many of the audits covered periods back to 1978, well before the many improvements to the Royalty Management Program were in place.

In addition, we informed the Investigative Staff that, in any case, these data should not be used to draw valid conclusions about the amount of underpayments in the lease universe as a whole. In particular, the audit work reflected in the figures was targeted on leases involving complex gas issues and Indian referrals where problems were thought to exist, and thus were not a representative sample of all leases.

The Department's Office of the Inspector General (OIG) made a similar point when it provided a preliminary analysis of the results of the 34 "lookback audits" to the Investigative Staff in December 1985. At that time, the OIG analysis indicated that underpayments amounted to 6.9 percent of total royalties paid during the period covered on the specific leases audited. In an April 18, 1986, letter forwarding this analysis to Congressman Yates the Inspector general stated, "Any projections on the amount of total potential royalty underpayments on the basis of the information contained in the enclosed document would be invalid . . ."

A more recent analysis by the OIG staff of the results of the lookback audits indicates that underpayments might be said to have amounted to only 2.5 percent of royalties paid during the period covered on the leases audited. This appears to be more in line with the recent experience of MMS auditors. Computations performed in justifying a need for additional auditors indicate that a comprehensive audit program that covers all leases on a 6-year cycle might yield around $150 million annually in additional collections. This represents about 3 percent of total royalties collected in recent years.

In response to continuing efforts by others to arrive at an estimate of royalty underpayments, the OIG workplan for Fiscal Year 1987 includes a project to analyze a statistically valid sample of royalties from large and small payors in order to quantify and project underpayments or overpayments received by the Government.

To summarize, royalty underpayments exist. The extent of underpayments is uncertain due at least in part to uncertainties regarding what payment was due. We in MMS believe that due to the mounting of an aggressive audit program and other enforcement efforts, the extent of underpayment is less today than it was in the period covered by the OIG's lookback audits (i.e., 1977-1981). We further believe that underpayments will continue to decline as a result of: continued improvements in these compliance efforts; greater utilization of PAAS (or an alternative to it) and an enhanced AFS to generate potential audit targets; and the eventual publication of product value regulations that provide certainty to industry about the amount of royalty due.

Audits Have Identified Over $278 Million in Owed Royalties (pages 14 to 16)

First, we agree with the conclusion in the report that an aggressive audit effort is vital to the success of the RMP and that the effort to date has been one of the most successful aspects of the overall MMS program. To update the amounts quoted in the report, from program inception in October 1981 through August 1986, the audit program has resulted in $320 million of additional revenues. This amount includes $45.7 million in additional revenues collected (i.e., royalties and late payment charges) from the joint audit program conducted with States and tribes. The following is a listing by area of noncompliance.

ROYALTY COMPLIANCE DIVISION
CATEGORIES OF ADDITIONAL COLLECTIONS
OCTOBER 1, 1981 - AUGUST 30, 1986 *

	Area of Noncompliance	Amount
o	Incorrect Pricing/Value	$109,135,000
o	Incorrect Production Volumes	26,755,000
o	Incorrect Royalty Rate	26,345,000
o	Failure to Report or Pay on Production and/or Sales	15,763,000
o	Failure to Pay Rent and/or Minimum Royalties	162,000
o	Incorrect Gathering, Manufacturing, or Transportation Allowances	5,714,000
o	Take or Pay	4,762,000
o	FERC Order 94	4,755,000
o	Desk Audit of Royalty Reports	25,563,000
o	Miscellaneous Computational Errors	6,110,000
o	Late Payment Charges	35,531,000
o	Liquidated Damages	458,000
	TOTAL	$261,053,000
	Refund Denials	58,991,000
	Grand Total	$320,044,000*

* includes $19,240,000 collections of OIG findings

During this period, the MMS Royalty Compliance Division (RCD) auditors reviewed payments on 1,439 Federal onshore leases (8 percent of currently producing leases), 955 Federal offshore leases (67 percent) and 1,283 Indian leases (27 percent). Relatively less time has been spent by RCD on reviewing Federal onshore leases because audit responsibility for many of these leases has been delegated to State and Tribal auditors under the joint audit program authorized by FOGRMA.

MMS has collected $13.4 million in additional revenues since program inception as a result of audit activity involving Indian leases. In January 1986, BIA and MMS implemented a joint Indian lease audit strategy to enable the Bureaus to respond to Indian tribal and allottee lease inquiries in a timely, effective, and efficient manner. Tribal and allottee audit requests, following review by the appropriate BIA field office, are forwarded to the MMS audit division through a central BIA office also located in Lakewood, Colorado. The BIA office in Lakewood establishes audit priorities, and MMS has initiated audits of 40 Indian leases as part of the new Indian Lease Audit Strategy. During Fiscal Year 1986, MMS also performed the following in response to special requests:

- Audited 7 Indian leases in response to congressional requests resulting in $37,000 in additional collections.

- Audited 15 Indian leases in response to a U.S. General Accounting Office request resulting in $112,000 in additional collections.

- Audited 11 Indian leases in response to BLM requests resulting in $1.0 million in additional collections.

In all likelihood, audit collections since program inception would have been higher except for the fact that, especially during the early years of the program, auditors were diverted to other tasks necessary to manage the overall MMP. Many of these tasks are now behind us (see later discussion of RAS reconciliations), and RCD is moving into a period when it should be able to concentrate on its basic responsibilities. These include:

- Audit referrals from BLM and BIA, including referrals under the Indian Lease Audit Strategy and audits of nonstandard Indian leases.

- Self-initiated company/lease/subject matter audits.

- Oversight of delegated audits to States and tribes under FOGRMA, Sections 202 and 205, as well as cooperative audits of OCS 8(g) leases.

- Review of requests for recoupment or refund of royalty payments.

- Audit referrals identified as a result of the AFS and PAAS comparisons of sales and production data.

- Litigation assistance to the Solicitor's Office.

We are optimistic about increasing audit effectiveness in the coming years, particularly, as our audit division is allowed to spend more time on its basic responsibilities. In the fiscal year now ending, for example, we increased our audit coverage of Indian leases by over 40 percent. In future periods we hope to experience similar increases for Federal offshore and onshore leases.

The report notes on page 16 that we can expect to recover about $25 for every audit dollar expended. Our Fiscal Year 1986 average returns by lease type were:

Lease Type	Return Ratio
Offshore	16:1
Onshore Federal	6:1
Indian	2:1

Returns in many individual cases far exceeded the $25 figure. As we move more into a cyclical audit program, we will continue to attempt to maximize our returns. However, over time as more lease and payors are covered, the higher returns now being experienced should begin to decline.

North Dakota Tracking System (page 16)

The Department agrees that comparisons of reported royalties with production data can identify underpayments. The Department and the Royalty Management Advisory Committee are currently reviewing the extent to which onshore oil and gas leases should be brought onto the PAAS.

As to the exact amount of underreported or underpaid royalties on North Dakota oil, we will continue our Section 205 contract commitment to the North Dakota State Auditor to bill and collect all underpaid royalties identified by their audits.

Lease 255-030981 (page 16-17)

The Department agrees that audits result in the identification of underpaid royalties but wonders about the particular significance of this example. The MMS has collected over $320 million from audits of royalty payments during the period October 1981 through August 1986.

We have not completed our analysis of this case; however, we have learned that this case resulted in only a $26,000 collection because, after billing, yet another error was identified. Another payor had paid $20,000 of the suspected underpaid royalties.

Payors Deny Access to Records (page 17-18)

It is true that some companies have denied the MMS or OIG access to certain types of records. It is not true as the report of the Investigative Staff states that MMS has not taken any action on this matter. When the OIG or CPA contractors are not allowed access to records, they refer the matter to MMS for action. To date, 10 access to records demand letters have been issued by the MMS. Demand letters are official Agency orders issued under the auspices of Section 103 of the FOGRMA to oil and gas operators or payors. Seven of the companies complied and provided access to the records after receipt of the order. The MMS has pursued litigation with one of the companies, and has imposed civil penalties of $5,000 per day on another of the companies and will soon pursue litigation to gain access to the records and collect the civil penalty. The time to comply with the order for the last company has not yet expired.

The MMS does take the necessary action to gain access to records; however, we live in a society which believes in due process. Court enforcement of MMS orders can be a time-consuming process.

Ineffective Reconciliation Effort (pages 18-20)

The report concludes that efforts to reconcile account balances from the old RAS operation have not been productive and available resources should be redirected to auditing efforts. MMS agrees with this conclusion and has done so.

In response to General Accounting Office and Linowes Commission concerns, and the FOGRMA requirement that the Secretary "audit and reconcile, to the extent practicable, all current and past lease accounts . . . and take appropriate action to make additional collections or refunds as warranted," MMS has applied significant resources to reconciling out-of-balance RAS accounts. MMS's approach was to reconcile high balance Federal and all Indian lease accounts to a balance below which additional work was not cost effective. Also, RCD offered States with delegated audit authority the opportunity to reconcile accounts for those leases located in their State. Auditors from several states have participated in reconciliation efforts.

As the report states, reconciliation consists of analyzing the debits and credits for a lease account to determine whether any missing or misapplied charges or payments appear or should appear on the account. Reconciliation is an expedient means of confirming whether royalty computations, based on reported sales, agree with the royalty payments. Reconciliation does not include audit steps, i.e., verifications of production volumes and values and other steps that may; in the judgment of the auditor, be necessary to verify that all amounts due have been paid.

However, the following factual correction should be made. The report should read, "RCD has determined that, typically, balances below $100,000 should not be reconciled except for Indian leases" (rather than "audited").

As shown in the report a reconciliation may indeed as shown in the report produce different results from an audit. Audits are far more thorough involving verification of royalty and production reports against company records and includes verification that production is properly valued. Reconciliations simply balance the data reported to MMS, which may be erroneous.

RAS balances may be unreliable; however, they were not meaningless for reconciliation selection criteria as evidenced by royalty collections of nearly $4.2 million through August 1986.

The $100,000 threshold was sustained by an August 1985 OIG audit report. The "expedited reviews" were performed simply to ascertain the probable benefit of reconciling leases with balances less than $100,000. They were not intended as a substitute for necessary reconciliations.

The early reconciliation effort was cost-effective; however, more recent results have led to a different approach for the remaining onshore leases. Federal leases with unreconciled RAS balances will not be reconciled as a separate effort, but will be given priority in the audit planning process. Audits of such leases include RAS reconciliation steps.

However, given the special concerns of Indians, MMS plans to complete the reconciliation of all Indian leases by the end of 1986. The States, of course, are authorized to continue reconciling their lease accounts, if they desire.

Additional Revenues Collected by MMS for Erroneous Reports and Late Reporting (page 20)

This section appears to be essentially accurate but omits important aspects. The MMS began billing erroneous reporting assessments in April 1985. At that time, the criteria for assessment were a 7 percent or greater reporting error rate and a minimum of 25 erroneous lines. (An error is a condition causing a line to reject from the AFS and resulting in the system's inability to distribute the royalties reported on that line.) Beginning in July 1985, the threshold was reduced to a reporting error rate of 5 percent and a minimum of three erroneous lines. These assessments have served the purpose of helping encourage more accurate reporting. Rejected (error) lines, as a percentage of total lines reported, have dropped from an average of 12.45 percent in Fiscal Year 1985 to an average of 6.53 percent in Fiscal Year 1986 and were below 5 percent for the first time in August 1986. As of August 31, 1986, MMS had issued 739 erroneous reporting bills totaling $417,331.

The $10 per line assessments for late reporting and failure to report (nonrespondent) are automated processes which are considered a part of the AFS exception processing activity. These two conditions are treated similarly by the automated system, since whether a line is reported late or not at all, the system identifies it as not having been reported when due. These assessments differ from the late payment interest charges, because they apply to the report rather than to the payment. If a payment accompanies a report, as required by MMS regulations, and both are late, then the payor would be subject to both an interest charge and a late reporting assessment.

AFS late reporting assessments began as a manual process in March 1985. Initially, the criteria for assessment were 14 days late and a minimum of three lines. Over time, this threshold has been lowered until, beginning in September 1985, no grace period was allowed.

The nonrespondent assessment process (late reporting and failure to report) was automated beginning with the April 1986 report month. As of August 31, 1986, MMS has issued 1,728 nonrespondent assessment bills totaling $1,309,477 which includes the manual late reporting bills issued since March 1985.

The report fails to note that nonrespondent assessments are part of a much larger project called exception processing. Exception processing is the identification of conditions that result in billing actions. The AFS generates billable exceptions by comparing what a payor reports and pays to what the system expects the payor to report and pay. The following exception types are identified through the process:

- Royalty underpayment exceptions are created when the amount of payment received appears to be less than the royalties reported;
- Late payment exceptions are generated when the payment is received after the due date;
- Insufficient estimate exceptions are interest charges generated when the actual royalties paid 2 months after the sales month exceed the previously paid royalty estimates;
- Nonrespondent exceptions are automatically identified and generated when a payor fails to report or reports late for a particular AID, product code, and selling arrangement.

The first results of exception processing demonstrated the efficacy of the approach and its cost-effectiveness. As a result, MMS sought and obtained funding to hire a contractor to provide the resources necessary to complete 100 percent of the AFS exception processing bill verification. A contract providing for exception processing assistance was signed on October 17, 1985. However, because of the delay in the MMS Fiscal Year 1986 funding, the contractor was not able to begin hiring personnel until January 1986.

There are currently 49 contractor and 7 MMS personnel working on issuance of bills for interest, nonrespondent, and royalty underpayment exceptions as follows:

	Federal	Indian
o Contractor personnel	39	10
o MMS personnel	6	1

In addition to the above resources, extensive MMS staff time is devoted to activities relating to post-billing functions such as industry inquiries, appeals, stays (sureties), and collections on delinquent accounts.

Beginning in February 1985, MMS issued its first AFS late payment exception processing bill. The table below shows that as MMS implemented the various other exception processing modules, numerous bills and collections of revenue have resulted.

EXCEPTION PROCESSING - BILLS AND COLLECTIONS
February 1985 through August 31, 1986
($ in thousands)

Module	No. of Bills	Net Billings	Collected Amounts	Bonded, Pending Appeal	Balance Outstanding 1/
Federal interest	2,818	$16,340	$ 9,710	$5,370	$1,260
Indian interest	1,786	$ 852	$ 626	0	$ 226
Subtotals	4,604	$17,192	$10,336	$5,370	$1,486
Federal underpayments	30	$ 78	$ 71	0	$ 7
Indian underpayments	12	$ 20	$ 19	0	$ 1
Subtotal	42	$ 98	$ 90	0	$ 8
Nonrespondent	1,734	$ 604	$ 338	0	$ 266
Totals	6,380	$17,894	$10,764	$5,370	$1,760

1/ Of the outstanding balance, $1.5 million is not yet due from the payors and the remaining $.2 million represent delinquent accounts being pursued for collection by MMS.

Analysis of Nine Leases (pages 20-22)

The report includes a cursory review of nine leases for production/royalty volume and value differences. No overall conclusions are drawn, but the theme appears to be that royalty findings may be obtained through an analysis of MMS royalty reports and commercial production data or BLM's Form 3160-6. The report infers that a commercial production data source could replace PAAS. Experience has shown that extensive manual resources are required to assure that identified discrepancies are valid using this type of data. Even more manual resources are then required for resolution. However, PAAS performs this task with negligible manual effort, thereby permitting manual resources to be directed to the resolution and followup effort.

The nine leases analyzed are onshore leases and as such are not currently incorporated into the PAAS. Leases that are incorporated into PAAS are efficiently analyzed on a monthly basis to identify discrepancies between operator reported sales volumes and payor reported sales volumes. Currently, BLM and MMS cooperate in a joint effort to manually identify and resolve discrepancies for onshore leases. However, these manual efforts require extensive resources and are limited to discrepancies identified through BLM's production verification process.

The investigative staff analysis of nine leases points out the difficulties associated with manually comparing current Government and commercially available data with royalty data. Valid comparisons of production and royalty data must be thorough to distinguish apparent royalty differences from royalty misreporting which would result in no additional royalties. For example, when a unitized lease appears to be under or overpaid, based on a volume difference, all other leases in that unit must be researched to assure the difference did not simply result from misallocated sales or production. Likewise, when gas plant transfers are involved, all gas products must be reviewed to weed out product errors. Such difficulties greatly expand the effort required in a manual reporting environment. In the case of gas plant products, insufficient data was available to draw any conclusions concerning these leases.

The investigator told MMS staff he had no way of judging whether the differences were explainable (as simple misreporting) and did not search for evidence of payment on gas plant products. Not having the use of his workpapers, the staff attempted to reconstruct the analysis. They concurred with the two apparent oil shortages and are resolving them with the reporters. However, they found no way to sustain the gas-related differences. Neither the BLM data nor the commercially available data (derived from Government data) showed gas plant transfers. In addition, the analysis did not consider the unitized production from other leases participating in the agreements.

The complexity of making such comparisons is best illustrated by data for one of the 9 leases. The report indicates that underreporting occurred for lease 034544 on both condensate (oil) and gas. In just 7 months of 1985, the condensate was said to be underreported by $140,325. In addition, when allowances are made for Natural Gas Liquids (NGL) extraction, the gas sales were estimated to be underreported by about $912,000 for the 7 months of 1985. This lease is part of Communitization Agreement (CA) 691000016-0. To adequately research the discrepancy, MMS will have to request BLM to provide a complete listing of all the leases in the CA and their appropriate participating factors for the 7 months of 1985. (During discussions with the investigator, it became apparent that he was not aware that this lease was in a CA.) Upon receipt of this information from BLM, payor and product information is required from the lease operator to help resolve this discrepancy. These types of data are not commercially available.

MMS is working to complete the resolution of discrepancies for the nine leases. The MMS findings will be subsequently reported.

Average Prices for Crude Oil Indicate Lost Revenue (pages 22-26)

The preliminary report asserts a loss of royalty revenue related to crude oil produced on Federal and Indian lands in the States of Colorado, North Dakota, Oklahoma, Utah, and Wyoming. The analytical bases for the assertion are comparative differences found ". . . between the average price of crude oil and the average price received for crude oil produced from Federal and Indian leases . . . in six western States for 1978 through 1983."

The report states that the foundation for the analysis is the assumption that ". . . prices received for Federal and Indian crude oil should, in general, be the same as the average price received for all crude produced in the State. This assumption is stated to be valid where the Federal and Indian crude oil is a substantial part of the States' total production and the crude oil quality is comparable."

The assumption which serves as the foundation for the report's comparative analysis and results fails to consider the following factors:

1. Consistent Definition of Crude Oil
2. Quality Differentials
3. Location Differentials
4. Crude Oil Price Regulation
5. Crude Oil Windfall Profit Tax Act of 1980

The term crude oil can include "crude petroleum oil," "condensate" liquid hydrocarbons and "drip" gasoline recovered from natural gas by surface separators on the leasehold, at "drip" points on gas pipelines, or mechanical separators at gas plants. As stated in Williams and Meyers' Manual of Oil and Gas Terms, ". . . Crude oil is defined generally by twenty states as cruce petroleum oil and all other hydrocarbons, regardless of gravity, produced at the well in liquid form by ordinary production methods and which are not the result of condensation of gas. Some seven states include liquids which are the result of condensation and four do not define crude oil."

By comparison, MMS segregates oil, condensate and "drip" gasoline, by product code, for royalty reporting purposes. The above-described differences in definition of crude oil create significant distortions in statistical averages of prices because of the significant variances in sales values of the various hydrocarbon products which may be included in, or excluded from, "crude oil" price data gathering performed by state governments and Federal agencies.

Crude oil varies radically in its physical properties and, consequently, in its market value. Two physical properties which most significantly affect market value of crude oil are specific gravity and sulphur/hydrogen sulfide content. Other things being equal, the higher the specific gravity (on the API scale), the greater the value of the oil. Similarly, the lower the sulphur/hydrogen sulfide content of crude oil, the greater its value.

In the Rocky Mountain Region wide disparities exist in specific gravity and sulphur/hydrogen sulfide content of crude oil production. These same wide disparities also exist in production within individual states. Consequently, significant distortions in statistical averages of prices are created when comparisons on values of crude oil production from selected lands in a state are made to an aggregate average value of crude oil production in a state. The attached copies of oil price bulletins display the wide variance in market value caused by quality differentials.

The location of leases with crude oil production will affect market value. Basically, locations remote from pipeline facilities reflect lower market values due to the high cost to transport production by truck to a pipeline. Similarly, production from locations more remote from refiners will also reflect lower market values. These lower values may be reflected in posted prices or in transportation allowances considered in the calculation of value for royalty purposes. As a consequence of location price differentials, significant distortions in statistical averages of prices are created when comparisons of values of crude oil production from selected lands in a state are made to an aggregate average value of crude oil production in a state.

The Emergency Petroleum Allocation Act of 1973 and subsequent legislation established price regulation of virtually all domestic liquid hydrocarbon production. For crude oil, a series of tier categories was established to define maximum lawful prices which could be charged for crude oil. Certain crude oil was exempt from price regulation and, consequently, could be sold at market prices.

As a consequence of price regulation, the sales price of crude oil within a given state could, in 1980, vary by over $20 per barrel. Therefore, significant distortions in statistical averages of prices are created when comparisons on values of crude oil production from selected lands in a state are made to an aggregate value of crude oil production in a state.

The Act imposed a federal tax on so-called "windfall profits" realized by the oil industry from crude oil price decontrol. All domestic crude oil is subject to the tax with certain exceptions which include, among others, oil produced from State and Indian-owned lands. Production from Federally-owned lands is not exempt.

The rate of tax imposed on crude oil by the Act depends on the tier classification of the oil under price controls. The effective tax charge on a barrel of crude oil has ranged from no tax to about $15 per barrel. Though the "gross" sales price invoiced for a given barrel of crude oil should not have been affected, accounting treatment of the transaction by state governments and the MMS in the aggregation of statistics can result in varying values associated with the same given barrel of crude oil. Consequently, significant distortions in statistical averages of prices can be created when comparisons on values of crude oil production from selected lands in a state are made to an aggregate average value of crude oil production in a state.

Collection of Interest and Payment of Interest (page 26-28)

The report states that MMS is in the position of nearly always having to pay interest on Indian royalty payments. This is not true. The MMS is in the position of almost never having to pay interest on Indian royalty payments. In an order dated September 19, 1986, the District Court for the District of New Mexico said that the FOGRMA requires the Department ". . . to deposit royalty payments in plaintiffs' IIM's (Individual Indian Money Account) within 30 days after defendants' receipt of royalties from lessees." But as the report further states, MMS and BIA have taken steps to have Indian royalty payments invested in interest bearing accounts the day of receipt. The BIA has issued a contract which will develop the necessary computer software to allocate this interest received to the appropriate IIM account.

The report says the MMS did not begin billing payors for late payments until February 1985 (Federal leases) and April 1985 (Indian leases). The Department has been charging interest on underpayments for offshore leases since 1979 when interest regulations were adopted and since March 1, 1981, on underpayments for onshore leases when applicable interest regulations were adopted. It is since February 1985 that computer-detected late payments have been immediately assessed interest.

The identification of late payments and calculation of interest charges are functions performed both automatically by the AFS and manually as a result of audit findings. Interest collections are shared with the States and Indians, in accordance with Sections 111 (c) and (g) of FOGRMA. The States participate to the extent of their share of the royalties on which the charge is based. Indian Tribes or allottees receive 100 percent of interest collections attributable to their respective leases. MMS interest collections associated with billable exception processing and audit findings are as follows.

		In Millions	
	Federal	Indian	Total
Exception Processing (2/85 - 8/86)	$ 9.7	$ .6	$10.3
Audit Findings (10/81 - 8/86)	33.0	2.6	35.6
	$ 42.7	$ 3.2	$45.9

Production Verification is not Being Done (pages 28-29)

The BLM is responsible for production verification for onshore lease and MMS is responsible for offshore lease. Following is a summation of MMS production verification activities:

- The Pacific Regional Office has been verifying run tickets for oil sales since January 1985 and comparing them to PAAS production reports.
- Total discrepancies (plus and minus) of 22,000 barrels sold (out of 44 million barrels produced) have been identified and resolved;
- Inspections include steps to assure that meters are not by-passed and there are no sign of theft. Additionally, meter provings are regularly witnessed by MMS petroleum engineers and technicians;
- The Gulf of Mexico office has conducted a study of oil and condensate pipeline systems to verify reported sales. Descrepancies noted in the study are currently being examined by production accounting personnel and many appear to be reporting problems.
- The Gulf office is currently conducting a study to determine the most cost effective approach to doing production verification on a routine basis.

Production Verification Available from Commercial Sources (page 29)

To meet its lease and royalty management responsibilities, the Department collects production data tailored for specific purposes. Such data must be consistent in scope and sufficiently detailed.

Prior to the design of PAAS, the Department tasked a contractor to analyze production information being collected commercially for potential use in the comparison with royalty information. The contractor cited inconsistent data collection practices among the sources which would make it "extremely difficult" to match the commercial data to MMS data.

As a result of discussions with companies which provide such data, it became apparent that their data would not be conducive for royalty and lease management purposes. Such commercially available data is actually obtained from State Governments, BLM and MMS. Data from the State Governments varies substantially in reporting level (well, completion, lease, etc.), does not clearly identify Federal and Indian reporting entities and does not necessarily include the entity reporting numbers needed to make efficient comparisons with royalty data or perform the production verification function. Moreover, there is no legal requirement that the States continue to collect or provide this data to commercial publishers. Therefore, placing total reliance on such data would weaken the Department's effectiveness.

Lack of Valuation Guidelines has Created Confusion (page 30-31)

Pages 30 through 31 of the report state that while product value guidelines have been a top agency priority, they have yet to be issued which has resulted in audit findings being set aside, a confused industry, royalties paid on incorrect value, and State auditors making improper product valuation decisions. We believe the report should 1) acknowledge the existence of present valuation regulations which are being improved, 2) explain why the improved regulations have not been issued, and 3) note the Department's concern that the regulations adequately meet their intended purpose.

There are existing product value regulations which provide the valuation basis for payment of royalties. These are codified in 30 CFR 206 and in Notices to Lessees. These existing regulations provide significant discretion to the Secretary to establish value for royalty purposes. In many cases, they require royalty to be paid on a value substantially higher than was received by the lessee. Until August 1, 1986, when one of the Notices to Lessees was changed, value for gas was generally required to be equivalent to the highest applicable ceiling price under the Natural Gas Policy Act (NGPA) of 1978. With the current market condition for natural gas, many gas purchase contracts call for prices below NGPA maximum regulated prices. The new regulations will attempt to provide less discretion and more specificity in determining value for royalty purposes.

The Department, as stated in the report, has draft regulations covering the valuation of oil, gas, and coal, and allowances for transportation and processing costs. Because of the far reaching impact of such regulation to the States, Tribes and industry, the Department released these draft regulations in February 1986, and asked the Royalty Management Advisory Committee, composed of State, Indian, and industry representatives, to make recommendations on them. The Committee established three work panels to prepare a report and draft recommendations for the Committee's use. The work panels made reports at a Committee meeting held in July 1986. The oil panel presented a final report. The coal panel presented a final report but was evenly divided on several issues, and the gas panel presented only an interim report. To see if the issues raised by the coal panel could be resolved, the Committee appointed an ad hoc coal committee. Both are to report at a meeting scheduled for October 20-22, 1986. The Advisory Committee will still have many issues to resolve because the recommendations of the three panels are not consistent with one another. This panel exercise has clearly demonstrated the highly controversial and complex nature of valuation issues.

Lack of precision or inconsistencies in the guidelines has caused a few audit findings to be set aside. The audit finding in the El Paso case presented in the report as an example, however, was not such a case. It was set aside on appeal because the audit finding was based on the retroactive application of a rule issued June 1, 1977. The applicable rulemaking specifically provided for a prospective application only. Additionally, the amounts in question on which royalties were being considered had not been and could not have been paid to the company. Also, the amount was, in fact, not paid by the company while under appeal, and was not refunded. A performance bond had been filed with MMS pending appeal. It is important to note that the new regulations will be prospective and even if issued in 1983 would not have affected this 1981 audit finding by the Inspector General.

Transportation and Processing Allowances (page 31-32)

The report correctly describes the nature of the draft allowance regulations. However, MMS is unaware of any evidence that this policy ". . . has paid for most of the processing plants that process Federal and Indian natural gas." MMS also disagrees that these regulations include a new concept which greatly confuses and complicates such allowances.

Current MMS policy is to allow actual costs incurred by a lessee for processing gas from Federal and Indian leases. If processing costs are incurred under an arm's-length contract, MMS will accept as the processing allowance the actual contract cost limited to two-thirds of the value of the gas products. Currently, some Outer Continental Shelf (OCS) arm's-length gas processing agreements provide for the lessee to retain 100 percent of the residue gas and for plant owners to retain 100 percent of the liquids. The MMS also has knowledge of one onshore gas plant which charges lessees in excess of 100 percent of the value of the liquids to process their gas. In these situations, royalty is required on 100 percent of the value of the residue gas and one-third of the value of the liquids. If a lessee processes gas through a plant in which he has an ownership interest, MMS will accept the reasonable actual cost incurred by the lessee, limited to two-thirds of the value of the gas products. However, under no circumstances shall the amount of royalty on the residue gas and extracted substances be less than the amount which the Director determines would be payable if the gas had been sold without processing.

Depreciation is a component in both the OCS and the onshore processing allowance procedures for computing an allowance based on actual cost. By allowing depreciation, the lessee, over the life of the facility, may recover the cost of capital expenditures associated with processing the royalty portion of lease production, typically one-sixth for OCS gas and one-eighth for onshore gas. It should again be pointed out, however, that a lessee, in comparing the value of wet gas at the wellhead against the value of the gas and gas products after processing, will pay royalties based on the method which results in the higher value. When the value of the residue gas and liquids exceeds the value of wet gas at the wellhead, it may do so by only a fraction of a cent, which means that the use of the actual cost procedure is of minimum effect to the lessee in terms of recovering plant investment costs through depreciation. Therefore, the statement that the Department of the Interior has paid for most of the processing plants that process Federal and Indian gas is very questionable.

The report also criticizes MMS's "new concept" of establishing gas plant allowances on a plant owner basis rather than on a plant basis. The report is correct in that the allowance for each owner will be different, but not more complex. Furthermore, the allowance will be more equitable. At present, the plant allowance granted by MMS is an average of all plant owner expenses; some individual owners have higher plant costs, some lower. Under the proposed procedure, each plant owner will be given an allowance based upon his actual costs. Also, the approval process will be greatly accelerated. MMS will be able to review and approve individual plant owner allowances upon receipt rather than holding the approval until all plant owner data are received, which can exceed 6 months.

MMS Has Not Collected Penalties (page 32-33)

The MMS has issued 16 Notices of Noncompliance. Nine companies complied after receiving notice, two companies paid $8,610 in penalties for nonpayment of $1,480 in royalties, penalties are accruing at $5,000 per day on three companies, and one penalty of $20,440,000 is pending on appeal before the Interior Board of Land Appeals.

The MMS has developed a comprehensive enforcement and penalty strategy to promote prompt and accurate royalty reporting and payment. The tools used to carry out this strategy include (1) interest charges, (2) erroneous, late, and nonreporting assessments, and (3) civil penalties. Civil penalties are the enforcement action of last resort. They are intended for situations where a payor is willfully refusing to correct a violation or has repeated a violation many times and has shown no attempt at taking the necessary actions to prevent recurrence.

By law, penalties for nonwillful violations cannot be enforced until a payor has been provided an opportunity to correct the violation. The process begins with a demand letter or bill for collection. If this is not responded to, a Notice of Noncompliance is issued, explaining the violation and the remedies expected. The payor is provided 20 days from the date of service of the Notice to correct the violation. If this is not done, the civil penalty goes into effect. The payor is then expected to correct the violation and pay the penalty. The penalty continues to run, at a specified rate per day, until the underlying violation is corrected.

The first Notice of Noncompliance was issued September 29, 1984. To date, MMS has issued a Notice of Noncompliance in 16 cases. The status of these 16 cases is summarized below.

Issued	Status	Penalty Amount (Through 9/86)
9	Corrected violation before penalties accrued	-0-
2	Corrected violation and paid penalties	$8,610
3	Violation not corrected and penalty accruing (to be referred to U.S. Department of Justice)	$1,500,000
1	Decision by DOI Office of Hearings and Appeals upheld MMS, company is appealing. Penalty not yet collected.	$20,440,000
1	Notice of Noncompliance mailed September 11, 1986	Pending

In addition to the 16 cases, another 8 candidates for civil penalty were contacted by telephone and encouraged to correct their respective violations before MMS mailed the written Notice of Noncompliance letter. The violations were corrected by these 8 companies before the Notice was issued.

Civil penalty actions are in addition to erroneous reporting and nonrespondent assessments, and late payment interest billed at the IRS penalty rate, as previously discussed.

Theft of Oil and Gas From Federal and Indian Leases Continues (pages 36-39)

MMS is advised of theft of oil and gas from Federal and Indian leases by BLM. In those cases where 1) BLM determines the loss to be avoidable, and 2) where the volume is sufficient to justify such action, MMS assesses royalty charges. Almost all theft reports received by MMS were prepared by BLM offices in New Mexico.

MMS has collected additional royalties and late payment charges in association with stolen oil referrals as follows:

Royalty Payor	Royalty	Payment Date	Late Payment	Payment Date
Apache Corporation	$ 2,793.29	9/13/85	$1,493.23	11/12/85
Samson Resources Co.	$12,491.82	8/13/84	$6,687.39	9/28/84

On page 37, the report indicates that MMS may not be acting upon thefts of oil and gas from Federal and Indian leases. It is true that the majority of the reports as discussed below are merely filed.

In Fiscal Year 1986, MMS received 93 theft reports. Of these, 91 included a determination of unavoidable loss and two included a determination of avoidable loss. One avoidable loss was a 10 barrel loss and the other was a 2 barrel loss. MMS determined these losses to be too small to justify assessing additional royalty charges.

Blanchard Decision May Have Resulted in Substantial Losses to Oklahoma Indians (pages 40-41)

As stated in the report, the Blanchard Decision refers to a decision made by the Oklahoma State Supreme Court in 1963. In essence, the decision guaranteed that all oil and gas royalty owners of unitized and communitized tracts would be paid royalties from all sales of production within the pooled property regardless of the various contractual agreements. Prior to the Blanchard Decision, payments to royalty owners for pooled production were subject to contractual decisions by purchasers and lessees. The Blanchard Decision provided that a basic 1/8 royalty was to be allocated among all lessors, proportionate to his percentage of the unit. Any royalty obligation in excess of the 1/8 rate was to be paid by the lessee. Contrary to the statement made in the preliminary report, the Blanchard Decision assumed equal productivity across all acreage committed to the pooling agreement.

In May 1967, USGS implemented the policy of calculating royalty according to Oklahoma State law. MMS continued the policy put in place by USGS until July 1985, when Oklahoma Senate Bill 160 replaced the Blanchard Decision. MMS informed payors in November 1985 to begin reporting Oklahoma lease royalties the same as they reported for leases in other States.

Contrary to the emphatic statement made in the report, MMS does not have consistent data to prove that application of the Blanchard Decision did or did not harm Indian royalty recipients. Furthermore, the investigative staff has not provided the MMS with any empirical data to support their statement.

MMS audits have shown that application of the Blanchard Decision both favorably and unfavorably affected royalties. Concerns voiced by Indian allottees about the effect of the Blanchard Decision on their royalties have focused on the "excess royalties" aspect. Scheduled audits and audits conducted in response to these concerns have not identified a significant number of cases of nonpayment of excess royalties due Indian royalty owners.

2/25/86

REPORT ON FICTITIOUS ROYALTY DOCUMENTS (MMS-2014) FILED BY THE SURVEY AND INVESTIGATIONS STAFF, HOUSE COMMITTEE ON APPROPRIATIONS

INTRODUCTION

On October 1, 1985, the Minerals Management Service (MMS) received four "Reports of Sales and Royalty Remittance" (MMS-2014) ostensibly filed by four payor companies (Anadarko Production Co. (sic); Koch Oil Co.; The Permian Corp.; and Unicon Producing Co.). MMS was subsequently advised by letter dated December 17, 1985, from the Assistant Director, Survey and Investigations Staff, House Committee on Appropriations, that these four reports were fictitious and were submitted by the Staff "to ascertain whether or not adjustments such as those appearing on the four reports would routinely be processed or if the system would reject the transactions." This report summarizes the events which transpired from the time of receipt to the date of notification, the impact on the Auditing and Financial System (AFS), and the potential impacts had the reports been processed further.

BACKGROUND

The AFS design is based on the concept of voluntary reporting and paying by Federal and Indian mineral royalty payors. If payors wish to intentionally file false reports, they do so with the risk of being audited in a variety of ways including MMS audits (Royalty Compliance Division), state cooperative and delegated audits, Office of Inspector General audits, contract audits, and possibly automated comparisons of production and sales reports vis-a-vis AFS/Production Accounting and Auditing System (PAAS) comparisons. PAAS is currently operational for offshore payors and a few pilot onshore payors. This system of voluntary reporting and paying is comparable to the IRS system where intentional misreporting or nonreporting carries a risk of being detected through system edits or audits but at the same time there is no guarantee that all obligations are reported and paid.

There are certain administrative characteristics inherent in the AFS which, under normal operating conditions, help preclude improper and inaccurate reporting. For example, MMS assigned payor codes must be combined with knowledge of the proper account identification numbers (i.e., lease numbers, revenue sources, product codes, and selling arrangements) in order for reported royalty details to be accepted into the system. Those in a position to know these combinations include the payor, MMS, and those whom MMS can trust to maintain the confidentiality of such information (e.g., various audit and investigative groups who have a "need to know").

CHRONOLOGY OF EVENTS

On October 1, 1985, MMS' Lakewood Accounting Center received MMS-2014 royalty reports from four different payors. Although the reports were subsequently found to be fictitious, MMS processed them during October along with the other 3,000 MMS-2014 documents which are received each month at the accounting center. (Note: Each of the false documents contained valid payor codes, lease numbers, revenue sources, product codes, and selling arrangements.) None of the four reports were accompanied by a check or other documentation. Summarized below is an account of the actions taken by MMS in processing each of the false reports.

Anadarko Petroleum Corporation

10/01/85	Received the report of royalty due (transaction code 01) on 31.38 mcf at $3.31 per mcf = sales value of $103.92 x 12.5 percent royalty rate = royalty due of $12.99. The royalty report indicated payment method 01 (amount of checks to MMS). Although the MMS-2014 indicated payment by check, the report was not accompanied by a check. This condition resulted in preparation of a front-end problem report, indicating that the company owed MMS $12.99. (See Attachment A.)
10/09/85	Form MMS-2014 processed through the Auditing and Financial System without any errors.
11/14/85	Letter mailed (see Attachment B) to Anadarko informing them that we received a Form MMS-2014 without payment in violation of the Payor Handbook and the Federal Oil and Gas Royalty Management Act (FOGRMA). Continued violation would subject the company to the penalty provisions (up to $10,000 per violation per day) of FOGRMA.
11/22/85	Received telephone call from Mr. Jimmy Wood of Anadarko. After extensive research he was unable to find the preparer of this report.
11/22/85 through 12/16/85	MMS' Fiscal Accounting Division (FAD) contacted MMS' Royalty Compliance Division and the Wyoming State Auditors to determine if they had prepared the Form MMS-2014 in conjunction with audit efforts. We researched the lease to identify other companies who have an interest in the lease to determine if the preparer worked for any of those companies.
12/16/85	Received letter from Mr. Jimmy Wood stating that the preparers were not employed by Anadarko Petroleum Corporation (see Attachment C).
12/20/85	Received an explanation from the Committee Staff (letter from Mr. Nosik dated December 17, 1985).
12/26/85	Mailed a copy of the Form MMS-2014 to Anadarko per their request.
01/29/86	Letter of apology sent to Anadarko Petroleum Corporation (see Attachment D).

02/06/86	MMS-2014 prepared and fictitious transactions removed from AFS.
Current Status	Actions completed.
Impacts	MMS was placed in a highly embarassing position with the Anadarko Petroleum Corporation. The company received a letter from MMS threatening civil penalties. We are in the process of preparing a letter of apology to the company. Also, at least 5 staff-days were expended in tracking the false report. Unknown resources were expended by the company. The impact on the AFS was minor. Although the royalty line ($12.99) was accepted, no funds were distributed.

Koch Oil Company

10/01/85	Received a report of sales and royalty remittance which attempted to transfer royalties reported in July 1984 from a North Dakota lease to a Wyoming lease.
10/09/85	Form MMS-2014 submitted for normal processing. The two royalty lines rejected because the preparer used an improper adjustment reason code.
10/16-17/85	Because the attempted transaction involved transfer of funds between two states, Koch Oil, Koch Exploration, Koch Hydrocarbons and Koch Industries were contacted to determine who prepared the Form MMS-2014. Luff Exploration, Prima Petroleum, Amoco, and Eighty-Eight Oil (the operators) were also contacted. Inquiries were made of the MMS' Production Accounting Division, State and Tribal Support Office, Office of External Affairs (who contacted North Dakota, Montana, and Wyoming State Auditors), Royalty Compliance offices in Denver, Tulsa, and Houston. None of those contacted claimed any knowledge and the documentation was turned over to the Assistant Chief, Lessee Contact Branch. Since the document did not clear the AFS processes, and no dollars were involved, MMS suspended further actions.
12/20/85	Received an explanation from the Committee Staff (letter from Mr. Nosik dated December 17, 1985).
12/31/85	Fictitious lines were deleted from the error suspense file.
01/29/86	Letter of apology sent to Koch Oil Company (see Attachment E).

Current Status	Actions completed.
Impacts	MMS was placed in a somewhat embarrasing position with Koch Oil Company and at least 5 staff-days were expended in tracking and responding to the false report. A potentially sensitive situation was avoided only because the royalty report failed to clear system edits. However, if the proper adjustment codes had been used, funds would have been transferred from North Dakota's account to Wyoming's account, and additional scarce resources would have been commited to correct a fictitious endeavor.

The Permian Corporation and Unicon Producing Company

The circumstances surrounding these two false reports are substantially identical.

10/01/85	Documents were received from Permian and Unicon which attempted to reduce reported royalties of $3,751.63 and $16,361.80 respectively.
10/09/85	Both documents processed through the AFS and rejected because an invalid adjustment reason code was used.
10/13/85	MMS unilaterally corrected the adjustment reason code and both documents were accepted into the AFS.
10/31/85	Since each document totaled to a net negative dollar amount the result was a negative distribution to North Dakota and Wyoming which resulted in "unidentified" cash being created for each payor. The cash provided by the states of North Dakota and Wyoming was $16,361.80 and $3,751.63 respectively. A routine MMS procedure (an account receivable problem report) would have disclosed the discrepancy in January 1986 if the House Survey and Investigations Staff letter had not been received on December 20, 1985. The procedure would have resulted in MMS contacting the payors to determine the disposition of the "unidentified" cash created by the "net negative" document. At that point the document would have been discovered as false.
01/18/86	Reversing MMS-2014 prepared and the effects of the Permian false document were removed from the AFS.
02/25/86	Reversing MMS-2014 prepared and the effects of the Unicon false document were removed from the AFS.

Current Status	Actions completed.
Impacts	The impact on funds distribution is far reaching. With regard to the Permian Corporation report (a public land lease) MMS reduced its regular monthly payment to the State of Wyoming by $1,875 (one-half of the adjustment amount). The Unicon Producing Company report (a U.S. Forest Service Grasslands Lease) is more complicated. MMS does not deal directly with states when grassland revenues are involved. Rather, MMS distributed to the surface agency (the U.S. Forest Service). The Forest Service, in turn, disburses to the states. In this case MMS reduced the disbursement to the Forest Service (after crediting the Windfall Profits Tax account by about $385) by $15,976. The Forest Service shares 25 percent of its grassland receipts with the state in which the revenue was generated. They disburse to the state on an annual basis only, based upon the accumulation of disbursements it receives through December 31 of each year. Therefore, the Forest Service reduced its annual disbursement to the state of North Dakota by about $3,994 ($15,976 x 25 percent) in January 1986. If a special adjustment cannot be accommodated the state of North Dakota will not recover the erroneous deduction until January 1987, and MMS would incur late payment interest costs of approximately $500.

CONCLUSIONS AND COMMENTS

There is no question that individuals who possess proprietary knowledge coupled with internal system knowledge can cause havoc. MMS carefully controls the proprietary data submitted by payors to assure that such data is not released to unauthorized individuals.

MMS is deeply chagrinned and disappointed that data which was entrusted to the Committee Investigations Staff was used in a manner which caused embarrassment and temporarily corrupted the data base. If other, less risky alternatives had not been available, then these actions would be more plausible. However, MMS would be the first to concede that intimate knowledge of company codes and accounting data coupled with internal AFS system codes will allow access to the AFS. Also, MMS maintains a test data base which can be made available to external audit groups to experiment with any data processing scenario. We believe it is a credit to the system that, despite what was done, the false reports were detected on the front-end, or would have been detected on the back-end had the charade been allowed to continue.

MMS has not received any feed-back from either Anadarko Petroleum Corporation or Koch Oil Company after letters of apology were sent explaining the false documents.

Review of a Preliminary Report Entitled "Royalty Management Program" Department of the Interior

Introduction

The Minerals Management Service (MMS) has conducted an initial review of the preliminary report prepared by the investigative staff of the Committee on Appropriations of the House of Representatives. The conclusion of that review is that the preliminary report does not provide an accurate, balanced, or correct assessment of the history of the Royalty Management Program. It overlooks the progress that has been made in the program as well as certain continuing problems, and ignores projects underway or planned for further improvement. In short, it does not provide a complete and informed diagnosis of the health of the program.

In many places the report is factual; in others, it is in error. In many cases, facts are misinterpreted and lead to erroneous conclusions. In some cases problems are accurately identified but attributed to the wrong causes. In yet others, the authors simply mistake the facts in apparent confusion. The report generally lacks supporting facts, illustrations, and adequate explanation to provide context. Further, it has no apparent organization and thus tends to repeat material covered earlier, as though it was being newly introduced. Finally, it makes no suggestions for improvement.

For the above reasons, it is difficult to provide a clear and cogent response to the report. Thus, the MMS response is in two parts: (1) a page-by-page Commentary on the preliminary report which attempts to correct misstatements and erroneous conclusions, acknowledge correct information, and provide additional information that would help a reader assess the accuracy of the material presented and, thereby better understand the Royalty Management Program; and (2) this Review which provides a systematic framework for understanding the Royalty Management Program, its current status, and the comments in the preliminary report.

Overview of the Royalty Management Program

The Royalty Management Program consists of five primary elements: payment, collection, distribution, verification, and enforcement.

I. Payment

Owners of Federal and Indian leases by regulation and the terms of the leases are typically required, once a year, to pay a lease rental fee based on acreage when a lease is not yet in production. This is a relatively simple calculation. Approximately 94,000 leases are in this status and lessees make these payments to MMS for Federal leases and to a tribe, allottee or Bureau of Indian Affairs (BIA) for Indian leases. Owners of producing leases are typically required by the last day of the month following the month of production to pay a royalty on the value of production removed or sold from a lease. This is a far more complex calculation involving computation of product quantity and quality (sometimes for many products), value, processing allowances, and transportation allowances. A lease may have more than one owner and the products may be sold to more than one purchaser at a variety of prices. Many producing leases are part of a production unit or communitization agreement whereby production from a group of leases is allocated to individual leases by agreement. These units can involve various combinations of Federal, Indian, State, and private lands.

Each payor for a lease is required to report quantity removed or sold, value per unit, and royalty amount for each product removed or sold. Approximately 86 percent of the royalties are made by wire transfer; most of the remainder is made by check. Because of the complex nature of the production and sales operations, precise calculations of volume and value often cannot be made until long after the month of production. For example, production in a unitized area may be reallocated by lease because some wells produced more than or less than projected over the course of a year. Or, quality and price adjustments may be made retroactively after tests by the seller or purchaser, requiring a royalty adjustment later. Many payments are made on an estimated basis and require adjustment because actual volumes and prices are not available at the time royalties and royalty reports are due. The Federal Energy Regulatory Commission (FERC) rulings can affect prices retroactively for a number of years. Allowances virtually always are based on estimates and adjusted to actual amounts on an annual or biennial basis. Finally, a substantial portion of minerals production is sold at less than arm's-length; thus values placed on intra-company product transfers may be self serving and not reflect market values.

While the preliminary report appears critical of the complexity of the payment and reporting processes, these considerations are not the creation of Royalty Management. In fact, they reflect the underlying complexity of the private minerals market among many lease owners, lease operators, and product purchasers. Because of this, there are Federal regulations, instructions, and decisions which define when and how production will be measured, valued, and reported, and how royalty payments will be calculated and paid.

The preliminary report (pages 30-31) alleges that a lack of valuation guidelines has created confusion. Actually, guidelines have been in place for many years but are undergoing revision to make them more clear and current. In some places, the regulations have been abundantly clear - as in valuation for natural gas at FERC price ceilings - but have been outdated by changes in the market. In some cases, the current regulations set standards (such as pricing based on median field prices) that a lessee cannot be aware of and therefore cannot use in making payments. In other cases, valuation regulations and decisions have been challenged in litigation or appeals.

Rewriting the regulations is a massive task not only because of the tremendous variety and number of different situations that must be addressed, but also because a great many policy issues must be decided in such regulations. There is no underlying consensus on them. The States and Indians typically take a position based on how much money they may gain or lose compared to current practice. Industry favors regulations that require them to pay less than current regulations and oppose aspects that could increase payments. Industry also believes that the regulations should reflect and provide for acceptance of rapidly fluctuating financial conditions in the marketplace. These issues are hotly contested. Neither industry nor States and tribes like the current regulations. The Federal government has been in court with both regarding their interpretation. When the new rules are published, it is probable that both sides will still be unhappy and further litigation could ensue.

The MMS is trying to develop rules that will be clear, comprehensive, and fair. Draft proposed rules were completed in January of 1986 and released to the public for comment. They were also provided to the Royalty Management Advisory Committee (which is made up of representatives from the States, Indians, and industry) for review since we would like to develop a Federal, State, Indian and industry consensus on as many aspects as possible. The Advisory Committee has had three separate panels (coal, oil, and gas) assessing the draft rules and proposing changes. Their reports will be reviewed by the full Committee in late October and any recommendations of that group will be submitted to the Department for consideration. The public comments and Advisory Committee recommendations will be taken into account and proposed rules issued. These will be reviewed through an Administrative Procedures Act process before final rules are issued. We anticipate completing this process during FY 1987.

The preliminary report indicates that this effort to improve valuation guidelines is overdue. The MMS agrees. But the approach underway should result in a more careful and knowledgeable rulemaking than would have been possible without publishing draft proposed rules and having a review by the public and the Advisory Committee. It should also lead to consensus on some issues and a better understanding by the various interested parties of the magnitude of the issues MMS faces in dealing with product valuation.

II. Collection

Payors are responsible for payment; MMS is responsible for the bulk of the collections. The MMS has three major revenue and information collection systems:

1. BRASS. This is the Bonus and Rental Accounting Support System which accounts for and distributes annual rentals for nonproducing Federal leases. This function was historically the responsibility of the Bureau of Land Management (BLM) and was transferred in FY 1983 to MMS; the new system, BRASS, became operational in FY 1984. It runs adequately on one VAX minicomputer. The system was designed under contract for MMS and was implemented on time and within budget. It has been audited and only minor deficiencies noted. This system accounts for 94,000 leases. A validation of all leases has been completed with BLM and validation of all distribution codes is nearing completion.

2. AFS. This is the Auditing and Financial System which accounts for

und distributes royalties from producing or producible Federal onshore and Indian leases and all offshore leases. This will be discussed below.

3. PAAS. This is the Production Accounting and Auditing System. Operators of leases (who often are different than all or some of the payors) report production volumes, dispositions, and inventory changes for the various products. Information supplied to this system is compared to sales volume data supplied to AFS. Variations are noted and reviewed. If underreporting of production is detected, bills are issued and additional collections made. This system was tested during 1984 with a group of "pilot" companies and implemented in a production mode in February 1985 for offshore leases. Other onshore production is still reported to BLM. A decision was made in late 1984 to not implement onshore oil and gas lease reporting on PAAS until experience was gained in operating the system and a thorough benefit/cost study was prepared. This decision was made because it was clear that implementation for the remaining leases would be difficult and expensive for both the Government and industry and potential benefits had not been quantified. The leases implemented on PAAS in February 1985, represented the easiest part of the implementation because of an existing and largely adequate and correct data base for offshore leases. The study is nearing completion. A panel of the Royalty Management Advisory Committee is also examining PAAS and alternatives to it and the full Committee is scheduled to review this work and make recommendations to the Secretary in October 1986.

   PAAS is on-line for all offshore oil and gas leases (approximately 2,000), all solid mineral leases (approximately 450), and for approximately 1,300 of the 23,000 onshore oil and gas leases. Overall, this represents only 17 percent of the productive leases but over 70 percent of the royalty revenue. In the past year, approximately $8.4 million has been collected due to underreporting of production detected through this system. This system operates adequately on a single minicomputer. Implementation of onshore oil and gas leases would require one or two additional minicomputers.

The Auditing and Financial System. The AFS has been a substantial problem. AFS was developed to replace the archaic and discredited Royalty Accounting System (RAS). It was designed under a contract awarded in 1980 with the software developed and operated under a separate contract awarded in 1981. In early 1981, MMS's predecessor agency made a decision to implement the system on a minicomputer rather than the original concept of putting the system on a mainframe computer. As the report notes, this was a serious mistake.

As implementation of the system neared, it became clear that a single minicomputer was inadequate and the system was reconfigured for three minicomputers. This resulted in several problems. Those problems were recognized during 1982 and plans were developed to obtain a mainframe computer and convert the system to it. Funding was sought through a budget amendment the next year and a request for proposals was issued in July 1983. Award of the contract was postponed in late 1984 due to questions raised in a report issued by the Interior and Insular Affairs Committee. That report called for delay until a post-implementation review of AFS was completed. Such a review was undertaken during the first quarter of 1985 and a decision was made to proceed with the conversion contract. This decision was not lightly made since it would require "freezing" the AFS (i.e., not making further improvements in it) until it was converted in order to adequately test the system on the mainframe computer. The judgment at the time, which is still considered valid, was that potential improvements were not significant enough to delay award, given the improvements that would be possible operating on a mainframe computer.

The conversion contractor, Martin Marietta Data Systems (MMDS) was to have completed systems testing by the end of December 1985, and turned the system over to MMS for 4 months of testing. Conversion work has gone much slower than anticipated with several major slips in the schedule. At this point, the system has been converted and MMDS is in the process of testing it and correcting problems that are detected. It is important to note that this conversion is not advertised as a panacea. After conversion, a variety of enhancements will be made to the system; some of these have already been turned over to the MMDS under the operation and maintenance contract. Even an enhanced and well running AFS, however, is not a panacea. The Royalty Management Program necessarily will continue to rely on the other aspects of the program as it was designed to do. Operating in the minicomputer environment led to many problems. The more major ones being that reference data was spread across three computers and could be synchronized only once a week, and the machines had not been designed for and were not capable of supporting substantial on-line data entry and error correction was difficult. Machine time also was not available to do many functions desired or to make improvements to the system. This latter element was particularly important since the Federal Oil and Gas Royalty Management Act (FOGRMA) was enacted in January 1983 after the system had been designed and developed That act added new requirements - particularly for monthly payments and reporting to States and Indians that could only partially be grafted on to the AFS operating in its minicomputer mode.

AFS matches payments, monthly reports, and "reference" data (standard information about leases and payors) to account for and distribute revenue and provide reports. This matching process is the major function of AFS. The process involves many edits of the payments to determine reporting accuracy - a major deficiency of RAS. The system is basically designed to assure an accurate match before further processing, distribution, and disbursement.

- Data Base Cleanup. As the preliminary report accurately notes, the data from the RAS which was transferred to AFS was often inaccurate. Additionally, payors were not used to reporting royalties in a highly accurate manner. As a result, the initial error rate was typically near 50 percent. What the preliminary report does not indicate is the extent of success in getting consistent reporting or the reasons for that success. Major efforts, both internally and externally, either have been completed or are well underway and continuing, that have substantially improved our operations are discussed below.

A number of actions have been taken to identify, correct, and prevent future data base errors. In October 1985, involved staff were reorganized to more effectively pursue the cleanup effort. Representatives from State and tribal audit groups, participating under the Intergovernmental Development Program, worked with MMS to assure the data base included all appropriate leases, completing that task in April 1986. As a result, 67 leases were added to the AFS and 345 added to the Bonus and Rental Accounting Support System (BRASS). Fund codes are being validated with the BLM and the BIA with completion dates of September 30, 1986, and December 31, 1986, for the Federal and Indian leases, respectively. Five new reports have been developed to aid in the evaluation of data base consistency. These reports summarize current and historical information on the detection and resolution of data base differences.

The Royalty Management Advisory Committee's Data Base Panel presented its report in July 1986, recommending:

- A continuation of MMS's current Management Action Plan defined data base validation effort with continued participation by States, tribes, and industry.
- An enhancement of the current AFS capabilities to provide increased accounting for nonstandard Indian leases. Also, the BRASS should be expanded to include nonproducing Indian leases.
- Formulation of a task force consisting of MMS, BLM, States, tribes, and industry representatives to define the objectives of the AFS data base and related system considering the impact of BLM's Automated Land Mineral Record System (ALMRS) and full implementation of the Production Auditing and Accounting System for onshore leases.
- Departmental action to combine and oversee, MMS, BLM, and BIA data bases into a consolidated interactive system accessible by all agencies and assign agency responsibility for accumulating, validating, and maintaining specific data elements.

The panel described the data base cleanup progress as "commendable".

In addition to the above projects, a systemic review of 90 royalty payors needing additional training on how to report and pay to the AFS was completed. Based on industry input, a training curriculum and plan was developed to provide this training. Twelve 2-day training sessions were conducted in six cities. These training sessions were completed in March 1986.

The combined effort of these two initiatives has resulted in a significant reduction in the AFS reporting errors. As shown in Table 1, the combined error rate recently dropped to below 5 percent and has been consistently below 10 percent for the past 12 months.

III. Revenue Distribution

On the distribution reporting side, the preliminary report criticized MMS for slow distribution particularly for rejected lines.

The above discussed accomplishments have enabled the RMP to continually increase the amount of money it can distribute and disburse on a timely basis. As discussed below, the reports must be received accurate or corrected before royalties can be distributed and disbursed.

Revenue collected by MMS from mineral leasing on Federal lands is distributed and disbursed to States, the general fund of the Treasury, the Windfall Profit Tax account, and a number of designated special-purpose accounts. All revenue collected from Indian leases are similarly distributed and disbursed by the BIA to the appropriate Indian tribes and allottees. All formulas for disbursements are established by law.

The complex process of determining proper distribution and disbursement of revenues is accomplished through the AFS. Intense system controls monitor the status of revenues from the point of receipt to actual disbursement. From the information submitted with the royalty report and payment, the computer automatically attempts to match each payment to its corresponding report. This matching process results in either matched or unmatched items. If a payment cannot be automatically matched to a report, it must be manually matched. Situations in which payments and reports cannot be matched manually may indicate to MMS that nonpayment or underpayment penalties should be assessed. In the past year, approximately 95 percent of collections have been paid out on schedule; the remainder need to be researched since cash and reported information need to be reconciled. These are usually cleared up in the next month.

Before the implementation of FOGRMA, States, tribes, and Indian allottees received no explanation of their royalty payments. As a part of the disbursement process, MMS has provided Explanation of Payments (EOP) Reports to Indian tribes and to BIA for their use in providing similar information to Indian allottees since October 1983. It has been known for some time that the reports need to be restructured for clarity and to provide additional information. As a temporary measure, special reports have been developed to overcome some of these problems. In the longer term, MMS plans to implement several enhancements to the AFS to provide a more information EOP. It should be noted that this requirement, though reasonable, was not incorporated in the original AFS design, because it stemmed from FOGRMA.

IV. Verification

First, because MMS anticipated that there will be discrepancies and delays in payment and reporting, it has several approaches to detecting and verifying that full payment has been made.

1. Audits

Payments made to MMS are subject to audit. There are approximately 2,000 companies and individuals that make royalty payments on over 24,000 producing Federal and Indian leases. The 25 largest royalty payors provide approximately 80 percent of the total royalty dollars collected while the next 150 payors provide an additional 10 percent of the royalties, and the remaining royalty payors the last 10 percent.

The MMS royalty audit program is implemented by its Royalty Compliance Division (RCD) and by State and tribal auditors working with MMS under delegated agreements and cooperative agreements. RCD audit resources are available from both mobile and resident audit teams. The mobile teams work on any audit assignment while the resident teams are permanently located at the accounting offices of the 13 largest royalty payor companies. To assure that mineral lease revenues are properly reported and paid, RCD has developed a multi-faceted audit strategy directed toward the following functional audit areas:

- Reconciliations of account balances in the former Royalty Accounting System as directed by the Federal Oil and Gas Royalty Management Act (FOGRMA).
- Resolution support and billing action for Office of Inspector General lookback audits.
- Audit referrals from BIA and BLM.
- Self-initiated company/lease/subject matter audits.
- Oversight of delegated audits to States and Tribes under FOGRMA, Sections 202 and 205.
- Review of requests for recoupment or refund of royalty payments made on Outer Continental Shelf (OCS) leases.

- o Audit referrals identified as a result of the AFS and PAAS comparisons of sales and production data.

- o Litigation support technical assistance to the Solicitor's Office.

Accomplishments total over $320 million from program inception in October 1981 through August 1986. RCD has reviewed payments on 1,439 Federal onshore, 955 Federal offshore, and 1,283 Indian leases with collections as follows:

MMS Audit Program Collections and Refund Denials
October 1, 1981 Through August 31, 1986

Additional Royalties		
Federal Offshore Leases	$ 53,621,550	
Federal Onshore Leases	41,350,635	
Indian Leases	10,852,291	
Total Additional Royalties		$205,824,477
Late Payment Charges		$ 35,530,733
Liquidated Damages		458,383
OIG Audit Collections		19,239,665
Refund Denials		58,990,534
TOTAL		$320,043,792

Audits are currently performed under FOGRMA Sections 202 and 205 delegations by the Navajo Indian Tribe and the States of Alaska, California, Colorado, Mon~~tana,~~ North Dakota, Oklahoma, Utah and Wyoming. In addition, cooperative agreements are in place with the State of New Mexico and the Southern Ute and Jicarilla Apache Tribes. These collective efforts have resulted in audit collections of $45 million or about 14 percent of the above total.

In the future, the RMP audit strategy will be directed toward auditing leases on a six-year cycle in accordance with FOGRMA record retention requirements. This strategy assumes the following:

- o Addition of 50 additional audit positions.

- o Continued participation by tribes and States in 202/205 audit activities.

- o Cooperative agreements for State audits of OCS Section 8(g) leases.

- Increased activity under the BIA/MMS Indian lease audit strategy.
- Increased audits of nonstandard Indian leases (some will require a 2-year audit cycle).
- Increased audits targeted by the AFS/PAAS comparison.

2. AFS Exception Processing

An additional function of the AFS is to detect late payments and certain types of underpayment. Implementation of this function, called "billable" exception processing, was delayed until February 1985 because of lack of computer capacity and staffing. This aspect of the program is barely touched on in the preliminary report, but represents a significant advance and has had a high payoff.

Exception processing is the identification of conditions that result in billing actions. The AFS generates billable exceptions by comparing what a payor reports and pays to what the system expects the payor to report and pay. The following exception types are identified through the process.

Royalty underpayment exceptions are created when the amount of payment received appears to be less than the royalties reported.

Late payment exceptions are generated when the payment is received after the due date.

Insufficient estimate exceptions are interest charges generated when the actual royalties paid 2 months after the sales month exceed the previously paid royalty estimates.

Nonrespondent exceptions are automatically identified and generated when a payor fails to report or reports late for a particular AID, product code, and selling arrangement.

The MMS sought and obtained funding to hire a contractor to provide the resources necessary to complete 100 percent of the AFS exception processing bill verification. While the AFS automatically identifies various exceptions, extensive manual review of the exceptions is necessary in order to be reasonably confident that bills issued to industry are accurate based on information readily available to MMS. This helps to keep payor inquiries and appeals to a minimum.

However because of the delay in MMS receiving its Fiscal Year 1986 funding, the contractor was not able to perform exception processing work until January 1986, and as AFS exception processing modules have been implemented, the staffing size has increased to the current level of 49.

In addition, there are currently 7 MMS personnel working on issuance of bills for interest, nonrespondent, and royalty underpayment exceptions as follows:

	Federal	Indian
o Contractor personnel	39	10
o MMS personnel	6	1

The table below shows that as MMS implemented the various other exception processing modules, numerous bills and collections of revenue have resulted.

EXCEPTION PROCESSING - BILLS AND COLLECTIONS
February 1985 through August 31, 1986
($ in thousands)

Module	Number of Bills	Net Billings	Collected Amounts	Bonded, Pending Appeal	Balance Outstanding [1]
Federal interest	2,818	$16,340	$ 9,710	$5,370	$1,260
Indian interest	1,786	$ 852	$ 626	0	$ 226
Subtotals	4,604	$17,192	$10,336	$5,370	$1,486
Federal underpayments	30	$ 78	$ 71	0	$ 7
Indian underpayments	12	$ 20	$ 19	0	$ 1
Subtotal	42	$ 98	$ 90	0	$ 8
Nonrespondent	1,734	$ 604	$ 338	0	$ 266
Totals	6,380	$17,894	$10,764	$5,370	$1,760

[1] Of the outstanding balance, $1.5 million is not yet due from the payors and the remaining $.2 million represent delinquent accounts being pursued for collection by MMS.

3. The PAAS/AFS Comparison

As discussed previously, PAAS is an integrated system of manual procedures and automated processes for minerals production reporting, accounting, and auditing. Production reports are submitted by lease/agreement and facility operators. PAAS is designed to track material produced from Federal and Indian lands from the source of production through inventory, measurement, and processing facilities to the point of disposition, with emphasis on the point of royalty determination. PAAS monitors all dispositions such as sales, injections, flarings, and conversions to other products to ensure there is accountability for all original production.

PAAS is designed as an extension of another MMS/RMP system, the AFS. AFS collects and accounts for royalties owed and paid for production from Federal and Indian leases. Based on data provided on production reports, PAAS identifies the amount of production that should be reported to AFS as sold. Sales volumes reported to AFS should match those reported to PAAS. The two systems were designed so that data would be compared regularly to identify instances of underreporting, overreporting, and nonreporting. To date, such comparisons for offshore leases have resulted in collecting over $8 million of additional royalties in the past year.

IV. Production Verification

The BLM is responsible for production verification for onshore lease and MMS is responsible for offshore lease. Following is a summation of MMS production verification activities:

- The Pacific Regional Office has been verifying run tickets for oil sales since January 1985 and comparing them to PAAS production reports.
- Total discrepancies (plus and minus) of 22,000 barrels sold (out of 44 million barrels produced) have been identified and resolved;
- Inspections include steps to assure that meters are not by-passed and there are no sign of theft. Additionally, meter provings are regularly witnessed by MMS petroleum engineers and technicians;
- The Gulf of Mexico office has conducted a study of oil and condensate pipeline systems to verify reported sales. Descrepancies noted in the study are currently being examined by production accounting personnel and many appear to be reporting problems.
- The Gulf office is currently conducting a study to determine the most cost effective approach to doing production verification on a routine basis.

V. Enforcement

MMS has a comprehensive enforcement and penalty strategy to encourage prompt and accurate royalty reporting and payment. The tools used to carry out this strategy include (1) interest charges, (2) erroneous, late, and non-reporting assessments, and (3) civil penalties. These three different types of enforcement mechanisms result from different provisions of the Federal Oil and Gas Royalty Management Act of 1982 (FOGRMA). Interest charges are mandated by Section 111 of FOGRMA. They are intended to compensate the U.S. Treasury for the loss of revenue resulting from late receipt of monies. Reporting assessments are a $10 charge for each line of data reported incorrectly or late, or not reported at all, on Form MMS-2014, the Monthly Report of Sales and Royalty Remittance. These assessments are authorized by Section 101 of FOGRMA as implemented by 30 CFR 218.56.

Civil penalties are the enforcement action of last resort. They are intended for situations where a payor is unwilling to correct a violation or has repeated a violation over time and has shown no attempt at taking the necessary actions to prevent recurrence. Authorized by Section 109 of FOGRMA, civil penalties can be applied to cases where a payor:

- o knowingly and willfully violates MMS reporting requirements;
- o fails to provide access to required records;
- o fails to comply with an MMS order; or,
- o fails to pay an amount due.

1. Interest Charges

The identification of late payments and calculation of interest charges are functions performed both automatically by the AFS and manually as a result of audit findings. Interest collections are shared with the States and Indians, in accordance with Sections 111(c) and (g) of FOGRMA. The States participate to the extent of their share of the royalties on which the charge is based. Indian tribes or allottees receive 100 percent of interest collections attributable to their respective leases.

The MMS has been charging interest on late payments as part of AFS exception processing since February 1985 and on audit findings since inception of the MMS Royalty Management Program (October 1, 1981). Interest collections for these periods have been as follows:

	Federal	Indian	Total
Exception Processing (2/85 - 8/86)	$ 9,710,000	$ 626,000	$10,336,000
Audit Findings (10/81 - 8/86)	32,960,743	2,569,990	35,530,733
	$42,670,743	$3,195,990	$45,866,733

2. Reporting Assessments

There are currently three conditions which lead to reporting assessments: erroneous reporting, late reporting, and failure to report. These latter two conditions are frequently referred to as nonrespondent assessments.

o Erroneous Reporting Assessments

Identification and calculation of erroneous reporting assessments is essentially a manual process. The MMS began billing these assessments in April 1985. At that time, the criteria for assessment were a 7 percent or greater reporting error rate and a minimum of 25 erroneous lines. (An error is a condition causing a line to reject from the AFS and resulting in the system's inability to distribute the royalties reported on that line.) Beginning in July 1985, the threshold was reduced to a reporting error rate of 5 percent and a minimum of three erroneous lines. The three line minimum results from it not being cost effective for MMS to process a bill for less than $25. These assessments have served their purpose of encouraging more accurate reporting. Rejected (error) lines, as a percentage of total lines reported, have dropped from an average of 12.45 percent in FY 1985 to an average of 6.53 percent in FY 1986 and were below 5 percent for the first time in August. As of August 31, 1986, MMS has issued 739 erroneous reporting bills totaling $417,331. The AFS does not segregate these assessments by Federal or Indian reports, since the collections are all returned to a single Federal account within the U.S. Treasury and are not shared with States or Indians. However, the assessment policy is consistently applied to all Indian and Federal reports.

o Nonrespondent Assessments

The $10 per line assessments for late reporting and for failure to report (nonrespondent) are automated processes which are considered a part of the AFS exception processing activity. These two conditions are treated similarly by the automated system, since whether a line is reported late or not at all, the system identifies it as not having been reported when due. These assessments differ from the late payment interest charges, as they apply to the report rather than to the payment. If a payment accompanies a report, as required by MMS regulations, and both are late, then the payor would be subject to both an interest charge and a late reporting assessment. AFS late reporting assessments began as a manual process in March 1985. Initially, the criteria for assessment were 14 days late and a minimum of three lines. Over time, this threshold has been lowered, until beginning in September 1985 no grace period has been allowed.

The nonrespondent assessment process (late reporting and failure to report) was automated beginning with the April 1986 report month. As of August 31, 1986, MMS has issued 1,728 nonrespondent assessment bills totaling $1,309,477 which includes the manual late reporting bills issued since March 1985. As with erroneous reporting these statistics are not maintained separately for Federal and Indian reports since the collections are not shared. However, the nonrespondent assessment policy is consistently applied to all Federal and Indian reports.

3. Civil Penalties and Notices of Noncompliance

By law, civil penalties cannot be enforced until a payor has been provided an opportunity to correct the violation to be penalized. The process begins with a demand letter or bill for collection. If this is not responded to, a Notice of Noncompliance is issued, explaining the violation and the remedies expected. The payor is provided 20 days from the date of service of the Notice to correct the violation. If this is not done, the civil penalty goes into effect. The payor is then expected to correct the violation and pay the penalty. The penalty continues to run, at a specified rate per day, until the underlying violation is corrected.

The first Notice of Noncompliance was issued September 29, 1984. To date, MMS has issued a Notice of Noncompliance and Civil Penalty in 16 cases. The status of these 16 cases is summarized below.

Issued	Status	Penalty Amount (Through 9/86)
9	Corrected violation before penalties accrued.	-0-
2	Corrected violation and paid penalties.	$8,610
3	Violation not corrected and penalty accruing (to be referred to the U.S. Department of Justice)	$1,500,000
1	Decision by DOI, Office of Hearings and Appeals upheld MMS; company is appealing. Penalty not yet collected.	$20,440,000
1	Notice of Noncompliance and Civil Penalty mailed September 11, 1986	Pending

In addition to the 16 cases, another 8 candidates for civil penalty were contacted by telephone and encouraged to correct their respective violations before MMS mailed the written Notice of Noncompliance and civil penalty letter. The violations were corrected by all 8 companies before the Notice was issued.

4. Other Enforcement Activities

A general theme over the last ten or so years is that the Department of the Interior (Department) has not taken actions to ensure that royalty payments are properly paid for production from Federal and Indian leases, and as a result, millions if not billions of dollars have not been collected in royalty payments. The Department through MMS has, in the last few years, taken a much more aggressive approach to ensure that royalty payments are properly paid. One way to demonstrate this aggressive approach is to describe the actions taken by royalty payors in response to orders of MMS to pay additional royalties.

Enforcement actions for the collection of additional royalties or for assessments of late and erroneous reporting and civil penalties are initiated by officials in the Royalty Management Program. To provide for due process, the Department has an administrative process by which these enforcement actions can be appealed to higher officials in the Department: first, to the Director of MMS, and second, to the Interior Board of Land Appeals (IBLA), as the Secretary of the Interior's representative.

From 1975 through 1982, there were on average about 35 to 45 enforcement actions appealed to the Director of the Geological Survey each year. In 1983 there were 46 appeals to the Director of MMS. There were 80 appeals in 1984, 350 appeals in 1985, and by September 1, 1986, over 500 appeals to the Director of MMS had been received.

These statistics certainly indicate that the current enforcement actions taken by MMS are much more hotly contested by royalty payors than were the enforcement actions taken in the past. The Director of MMS has not rendered a decision on all of the appeals received, but over 400 appeals have been processed so far this calendar year. In most cases, the original order issued by Royalty Management officials has been affirmed by the Director and the appeal denied. The following text will describe the issues contained in the appeals.

- Interior Board of Land Appeals (IBLA)

  After the Director of MMS renders a decision on an appeal, the appellant has the further right to appeal to the Secretary through the IBLA. There are almost 100 appeals pending with the IBLA dealing with the following general issues:

Pay pending appeal	- 6
Valuation issues	- 20
Late payment charges	- 10
Royalty on Lease use Gas	- 11
Section 10 - Two year Statute of Limitations	- 30
Untimely filing of notice of appeal	- 5
Assessments for late and erroneous reporting	- 5
Transportation allowances	- 6
Civil Penalties	- 3

- Enforcement Through Court Action

The Department of the Interior is also in Court with royalty payors over royalty payment issues. A royalty payor always has the option of taking any of our enforcement actions to Federal District Court. We anticipate that payors will begin to take many more issues to the courts for resolution. The following are the general issues where we are currently in court:

- Royalties due to Take-or-Pay Revenues.

Many gas purchase contracts require purchase of a minimum volume of gas, or in the absence of taking the minimum volume of gas payment for the gas with future make up of taking the gas. The MMS maintains that royalty is due when the payment is made, while payors maintain royalty is due only upon delivery of the gas. In addition, some producers and purchasers have entered into lump sum agreements in complete settlement of all of the take-or-pay liabilities. The MMS maintains royalty is due on these settlements while payors maintain no royalty is due. The Department is in litigation over this issue in both the Eastern and Western District Courts for the District of Louisiana. The MMS expects to soon be in litigation over this issue in other District Courts. Several dozen cases are involved in appeal or litigation.

- Valuation of Royalty-in-Kind

The MMS can receive royalty in either value or by receiving its royalty share of the product and selling the product directly to a purchaser. Many purchasers allege that MMS charged more than was authorized by price control regulations of the Department of Energy. The Department is in litigation over the issue.

- Coal Royalty Rate Readjustment

The Federal Coal Leasing Amendments Act of 1976 requires royalty on coal leases to be 12.5 percent of value while royalty for coal production for leases issued prior to 1976 are generally based on a specified amount per ton of coal produced. The Department renegotiates lease terms for coal leases every 20 years after the lease was issued. The Department has modified the royalty provisions in these older leases when they come due for adjustment and has imposed the 12.5 percent of value royalty rate. Many holders of coal leases have contested this practice and have sued the Department in Federal District Court.

- Valuation Issues - Royalty Due on Indian Leases

The Department has pursued litigation in several cases for collection of additional royalties for production from Indian leases. The general issues are valuation issues. Two particular issues are:

(1) the Department requires royalty value for processed

natural gas to be the higher of the value at the wellhead or the value of the gas and liquids after processing, and

(2) the Department requires the value of gas to be at a minimum the median price of all gas sold from a particular oil and gas field. The MMS often values natural gas at the highest applicable rate as provided for by the Natural Gas Policy Act of 1978.

o Nonpayment of Royalties in Bankruptcy Proceedings

The MMS is pursuing about 15 cases of underpayment or nonpayment of royalties by companies who have filed for bankruptcy under Federal law.

o Use of NGPA Price Ceilings as Value for Royalty

An issue which will eventually be litigated is the requirement under Notice to Lessees No. 5 which provides for valuing natural gas at the highest applicable ceiling price under the Natural Gas Policy Act of 1978. Beginning around 1983, new contracts for purchase of natural gas were often times at prices which were less than the highest regulated price. Payors generally paid royalties on what they received under the terms of their contract, but MMS through audit has assessed payors for additional royalties based on the higher price. There are a significant number of appeals to the MMS on this issue and the ultimate resolution of this issue will most likely be by the Federal Courts.

o Gas Valuation in the Kenai Field in Alaska

The MMS has been pursuing underpayment of royalties for gas produced from the Kenai Field in Alaska. A significant portion of these royalties is due the Cook Inlet Regional Inc., an Alaska Native Corporation. In 1985, the Department reached an out of court settlement with Union Oil Corp. in which Union paid $45 million in additional royalties and agreed prospectively to pay royalties on a specified formula. The MMS won its case against Marathon Oil Corp. in both District and Circuit Courts, and is now pursuing the actual accounting procedures to be used by Marathon in payment of royalties. This is expected to result in payment of millions of dollars in additional royalties.

o Conclusion

The description of the above enforcement actions is an indication of the much more aggressive approach currently being pursued by the MMS to ensure proper payment of royalties. Payors will always dispute certain payment obligations and it will still take years to get clear judicial decisions on many of these issues. The MMS is moving forward, however, to obtain clear guidance on the royalty payment obligations. It should also be obvious from the above description that it is not the lack of new product valuation guidelines that leads to disputes between MMS and payors over proper payment of royalties. Payors are challenging payment obligations even where the requirement in the existing regulations are clear. New product valuation regulations will strengthen the position of MMS to enforce certain valuation requirements, but there will still be significant numbers of disputes between MMS and payors over proper valuation of oil, gas, and coal for royalty purposes.

United States Department of the Interior
BUREAU OF INDIAN AFFAIRS
WASHINGTON, D.C. 20245

IN REPLY REFER TO:

OCT 1 1986

MEMORANDUM

TO: Director, Minerals Management Service

FROM: Deputy to the Assistant Secretary - Indian Affairs (Operations)

SUBJECT: Bureau of Indian Affairs Comments on the Preliminary Staff Investigation Report on Royalty Management

This transmits the Bureau's response to those sections of the report which deal most directly with royalty management issues affecting Indian lands.

Attachments

Fragmentation of Responsibilities:

The BIA has recognized the need to develop a common ground with other DOI agencies for implementation of a sound effective Royalty Management System. The BIA and MMS have established a joint BIA/MMS Steering Committee to meet periodically to identify and resolve common problems. Memorandums of Understanding (MOU) have been established with MMS and some State BLM offices. These MOU's have identified common oil and gas management objectives. We are in the process of implementing many of the identified objectives and will continue to meet periodically to work toward eliminating any barriers that might exist which preclude us from meeting the DOI Royalty Management Objectives.

Management Priorities and Commitment:

The Bureau's executive leadership has taken a more aggressive posture in working toward achieving the DOI Indian Royalty management objectives. This strategy includes a bureau-wide Royalty Management Organization structured at the Central Office level to facilitate the need of the field offices, the tribes and Indian allottees.

The Bureau's Office of Trust and Economic Development is taking the lead in the development and implementation of a viable, effective bureau-wide system, with objectives to manage and control the Royalty Management Program within the Bureau.

To illustrate the BIA's commitment to meeting the Royalty Management Objectives, three Central Office technical assistance teams have been established to assist in working toward problem resolution and systems development. Two of the teams are located in the Washington, D.C., Office to facilitate the implementation of a bureau-wide Integrated Records Management System (IRMS) and to implement a bureau-wide oil and gas royalty payment distribution system. A work force has been established at the Bureau's Lakewood, Colorado, Division of Energy and Minerals Office to accommodate interface development effort with MMS and BLM.

The BIA has recognized the Royalty Management problems and positioned itself to meet the DOI/BIA/MMS objectives.

Distribution of Financial and Human Resources:

An additional $960,000 has been allocated in the FY 1987 Energy and Minerals budget to cover expenses associated with corrective actions to resolve royalty payment problems from producing oil and gas leases, problems with other lease payments, land ownership records and integrated records management.

There are several factors involved in the establishment of funding for real property management throughout the Bureau. The majority of funding for this program is determined by tribes in the Indian Priority System budget process. Their decisions on funding for this program are considered in conjunction with funding needs for all other programs. However, in the 1987 budget, the Washington Office specifically targeted funds for addressing oil and gas royalty payment improvement needs and the basic source data that serves those needs as well as others. Additionally, an Integrated Records Management System Plan was signed by the Assistant Secretary on April 22, 1986. A project manager has been assigned to see that each segment of this Plan comes to fruition, within time deadlines established. Completion of these efforts will sharply enhance Bureau efforts to improve management and payments for oil and gas, as well as for other Indian natural resources.

BIA Abrogates Wind River Lease Cancellation

The Arapaho and Shoshone Tribes petitioned the Department of the Interior, in November 1981, to cancel Amoco's leases. In August 1982, an Administrative Law Judge was appointed to take evidence on the petition. Shortly thereafter, Amoco sued in federal court in Wyoming to enjoin the administrative proceedings on a variety of grounds, including bias and prejudice of the decisionmakers. In January 1983, the Government's motion to dismiss Amoco's suit was denied. Meanwhile, however, the lawsuit and administrative proceedings were stayed while Amoco and the Tribes attempted to negotiate a settlement. The Tribes never intervened in the litigation between Amoco and Interior.

In December 1985, while settlement discussions were still continuing, the judge threatened to set the issue of institutional bias for trial if there was no settlement by December 31. At that point, Amoco and the Department agreed that if the Department dismissed the petition without prejudice, Amoco would agree to dismissal of the lawsuit. The Tribes' attorneys were advised before the decision was made. Unfortunately, we understand that Amoco later withdrew its settlement offer--ostensibly because the price of oil had fallen so dramatically. As the administrative order of dismissal makes clear, if the Tribes desire, they may refile their cancellation petition with the Department at any time, without prejudice.

IN REPLY REFER TO:

United States Department of the Interior
3162.7 (630)

BUREAU OF LAND MANAGEMENT
WASHINGTON, D.C. 20240

OCT 1 1986

Memorandum

To: The Secretary

Through: Assistant Secretary - Land and Minerals Management

From: Director, Bureau of Land Management

SUBJECT: Responses To Issues Raised In Report Attached To Yates Letter Of September 11, 1986

Yates Report: Production Verification is not being done (pp. 28-29)

RESPONSE: Production verification to assure a proper accounting for all oil and gas produced from or allocated to jurisdictional leases is an important responsibility of the Bureau of Land Management (BLM). Audit and Inspection Interface is one of the four major areas addressed by the Memorandum of Understanding (MOU) between this Bureau and Minerals Management Service (MMS). Specifically, the MOU recognizes that field inspections by this Bureau may be necessary to resolve reporting or audit exceptions identified by MMS and, conversely, that audits by MMS may be required to resolve anomalies identified by this Bureau as a result of its production accountability routines.

The BLM carries out its responsibility through production accountability inspections. MMS carries out its responsibilities to verify proper royalty payments by conducting audits. Its audits make use of production data supplied by BLM. If fully implemented, the PAAS would facilitate this system by providing automated comparisons between sales and production information submitted by operators in such a way as to highlight those instances in which royalties may have been inaccurately paid. Audits or inspections of these leases would follow.

The BLM has a program for conducting annual inspections on every lease which can be reasonably expected to produce significant quantities of oil or gas or which has a history of noncompliance. Third quarter results indicate that over 75 percent of these high priority inspections for FY 1986 had been completed by the end of the third quarter. This suggests that most offices will reach 100 percent by the end of the fiscal year. In addition to these regular producing lease inspections, BLM also conducted an intensified nationwide production verification field inspection program on a selected number of leases. This activity included independent measurement by BLM's inspection force followed with a review of the lease operator's reports. During this pilot program, the BLM field offices, through August 1986, conducted 109 such inspections and only one anomalie was discovered, which has been reported to the MMS. The anomalie involved BLM approved off-lease gas measurement and subsequent sales to a gas purchaser, all of which is still under investigation. It has been concluded, however, that the anomalie would have been discovered by regular producing lease inspections. In addition, we are further analyzing the results to determine the merits of continuing this type of effort.

The report attached to the Yates letter makes the point that the Department should consider utilizing commercial sources for production information and conducting production verifications. The operator currently is required to submit production information on a lease basis to BLM. To purchase such data would not be in the best interest of the Government.

Yates Report: Drainage Problem has been exacerbated by issuance of IM 85-289 (pp. 33, 34, 35, 36)

RESPONSE: An important objective of BLM responsibility is to ensure that the Federal or Indian lessors are not subjected to revenue losses through the mechanism of drainage. The authorized officer must identify potential drainage situations (PSD), then analyze and make the determination, as applicable, to resolve such drainage situations. Resolution of the PDS may take the form of requiring the lessee or operator of the offended lease, unit, unit participating area, or communitized area to drill a protective well, to pay compensatory royalty, to enter into an agree (e.g., communitization, unitization, drainage, compensatory agreement) or to modify existing agreements.

BLM contracted with Keplinger Technology Consultants, Inc. to investigate, among other things, the drainage protection segment of the overall oil and gas reservoir management program. This independent study was completed with findings and recommendations presented to the Bureau in a September 1985 report. The Keplinger Report recognized many program shortcomings. Consequently, considerable BLM effort and resources have recently been expended to correct recognized deficiencies in the drainage program. Instruction Memorandum No. 86-702, dated September 11, 1986, to all BLM State Directors, transmitted the Final Report on the Development of Standards and Procedures for the Oil and Gas Drainage Identification and Determination Segments of the Reservoir Management Program. It is to serve as an interim guideline until such standards and procedures are incorporated into the Bureau Manual System in FY 1987. The subject IM supplements the Drainage Protection Manual Section 3160-2 and Handbook H-3160-2 and provides more detailed standards and procedures which in turn provide technical direction for identification of potential drainage situations, actual drainage determinations, and final resolution of drainage cases. Since this BLM IM addresses many of the deficiencies noted in the Yates Report, a copy is included.

Although the report attached to the Yates letter states that BLM's drainage problem was exacerbated by BLM IM 85-289, the BLM was implementing the "prudent operator rule" interpretation stemming from the Nola Grace Ptasynski appeal (63 IBLA 240), decided April 19, 1982, which permits a lessee to consider its own economic well-being in addition to that of the lessor. In addition, this theme was also developed in Manual Section 3160-2 and Handbook H-3160-2, issued May 21, 1984, as well as in a subsequent modification for "older drainage cases" presented in IM No. 85-289, dated March 4, 1985. Again, in order to assure clear guidance to the field offices on implementing the IBLA decision, this matter was readdressed in the aforementioned IM 86-702, dated September 11, 1986. The upcoming revision of the Manual and Handbook in FY 1987 incorporating the more detailed standards and procedures of this report also will reflect the modification contained in IM 85-289. In addition, the impact of IM No. 85-289 may be a fewer number of actual assessments issued since economic well determinations must be considered; however, the number of drainage reviews conducted are not altered by this change in instruction.

YATES REPORT: Theft of oil and gas from Federal and Indian Leases continues (pp.36-39).

RESPONSE: In addition to the normal procedures involved in oil loss investigation,BLM established a pilot program to determine the appropriate method for collecting data on losses or thefts of oil or gas from Federal and Indian leases. Two Area Offices were chosen for the pilot study: Farmington, New Mexico and Lander, Wyoming.

Farmington was chosen because it has a preponderance of gas wells that produce condensate as a by-product. This condensate is usually produced in relatively low quantities and must, therefore, be stored at the well site for a period of time until enough has accumulated to justify the cost of a tank truck to pick it up. The condensate, itself, is of a quality that can be successfully used, as is, to fuel an automobile. Loss of condensate has long been a problem in this area, but usually, the quantities are relatively small.

Lander was chosen because the Wind River Indian Reservation is in the Lander jurisdiction, and there have been allegations of theft on the Reservation.

The Pilot Program was initiated in June 1986. As of September 15, 1986, there were 18 reports of losses from Farmington totaling 292 barrels of condensate lost or stolen. No losses were reported from Lander.

Of the 18 losses reported from Farmington, 17 resulted in on-site investigations. There was no follow-up inspection conducted for the incident where only one barrel was reported lost. Estimated losses varied from one to 66 barrels. In each case where there was a follow-up, the operator was found to have been in compliance with BLM operating regulations, and an unavoidable loss determination was made.

In almost all instances, whether in the pilot areas or elsewhere, losses or alleged theft involve moving the product from the lease by some sort of motor vehicle. Thefts are seldom detected in progress as they usually take place outside of normal working hours and at night. Most losses are detected by the pumper after gauging a tank and comparing the volume on-hand with the pumper's record, or upon discovering a broken seal or some other evidence of unauthorized entry. Regulations 43 CFR 3162.7-4 requires operators to report all losses to BLM. BLM, if the operator hasn't, reports the alleged theft to local law enforcement officials, such as county and local police, and the FBI.

If during an inspection, a BLM Petroleum Engineering Technician (PET) should find evidence of theft, he reports it to the local police, the FBI, the operator and BLM's own law enforcement agents. He would also issue an Order or Incident of Noncompliance to assure the lease is brought back into compliance. Some of the indicators that might lead a PET or operator to suspect an alleged theft include: broken seal on a tank valve, unexplained truck tracts or unexplained volumes of oil having been in a water or emergency pit.

A data base has been set up by the Division of Inspection and Enforcement to analyze data, to determine if any patterns exist, to identify problem leases, or to detect other notable anomalies. Such findings will permit BLM to determine appropriate follow-up actions. Also, BLM will modify the program as needed and extend it bureauwide.

Mr. **Yates**. I continue with Senator McClure. "What the Commission found was that the Royalty Management Collection Agency for the Nation's energy resources has been deficient for more than 20 years."

Well, I think Mr. McClure's statement is an understatement. I think probably Interior has been wrestling with this problem since the passage of the Mineral Leasing Act of 1920. I really think it goes back that far.

Secretary after Secretary of the Interior has tried to wrestle with this problem and has been unable to adequately grasp it. Over the years, it has not been of the momentous importance that it now occupies or did occupy certainly during the years of OPEC's primacy.

Secretaries have been wrestling with it and haven't been able to deal with it. I am talking not only of you and of Mr. Watt, I am talking of their predecessors. Secretary Andrus couldn't do it, a Democratic appointee. Previous appointees couldn't do it.

It isn't a question of partisanship. It is a question of handling the people's resources. These are the people's resources. These are the Indians' resources.

The States are entitled to half of the collections. The Secretaries haven't been able to do it.

I look at what Senator Melcher says at the same time. I read December 6, 1982 on page S.13940. "The existing royalty accounting system was scarcely adequate during the period when the Federal revenues from royalties were measured in tens of millions of dollars."

"It is a disgrace in an era when these revenues are measured in the billions. In fact, most of the 'lost revenue' which has received so much publicity is not the result of theft. Rather, it is the result of a totally archaic accounting system which literally cannot account for the revenues it is supposed to monitor and assist in collecting."

My good friend on this committee is the ranking member, Mr. Regula, very smart, very good guy. In his questioning last year he said to you, "I don't understand why this should happen." Not last year, February 28, 1985.

He said he had personal experience with questions like this. He has represented farmers in their lease arrangements with oil companies. You draw up a paper, the oil company pays so much for its lease. It is supposed to give the farmer a certain amount and as he puts it now, he says if the farmer didn't receive it he would be raising hell in order to get that money. That is what the States are trying to do. That is what the Federal Government is trying to do.

Yet, there are two reasons why they can't do it. One is they don't know what goes into—the MMS does not know what goes into the data base and, two, they don't have the automatic system. I spoke to the Inspector General yesterday.

LOOKBACK AUDITS

He does not have the ability to conduct look-back audits. Were you aware of that, that he couldn't do that? I have a letter from him saying that. This is dated September 24, 1986 and signed by Mr. Richards. "This is to confirm our discussion with members of your staff in which I stated that the Office of Inspector General Fiscal Year 1987 budget request does not contain funds to contract with independent public accountants to make 'lookback' audits."

That is the only way you can do it is by making contracts with independent public accountants. "The last time our office was specifically funded for this activity was in Fiscal Year 1983. Our Fiscal Year 1987 budget request does include funds representing approximately six staff years for OIG to conduct audits of various aspects of the Royalty Management Program, including potential underpayments."

Why is that important?

The Inspector General is supposed to conduct lookback audits.

Mr. Bettenberg's staff does not conduct lookback audits, do you?

Mr. BETTENBERG. Of course we do, Mr. Chairman.

Mr. YATES. That is not the information we received before. How many lookback audits have you conducted?

Mr. REGULA. Will the Chairman yield?

Mr. YATES. Yes.

Mr. REGULA. I have the 1986 April report of the Inspector General and in here he says, "(. . . we began the following audit programs:) 1. "Lookback audits of the top 25 payors of oil and gas royalties on an accelerated basis which began at the end of fiscal year 1981. 2. Lookback audits of the second group of 25 royalties payors . . . which began at the beginning of fiscal year 1983."

Mr. YATES. Right. That is the last year he did it, Ralph.

Mr. REGULA. In 1983.

Mr. YATES. Right.

Mr. REGULA. Is this because we didn't give enough staff?

Mr. YATES. They never asked us for it. We have given MMS just about every dollar they have requested. They didn't ask for 50 additional auditors this year and we gave them 50 additional auditors.

The Senate knocked the money out.

Mr. REGULA. Excuse me, Mr. Chairman. Did the Senate take out the Inspector General money or what happened in 1985?

Mr. YATES. There was no request for funds by the Inspector General for this.

Mr. REGULA. Did we give them the same level of funding in 1985 as 1984 and 1983? Did we cut them, I guess is what I am asking, because they were able to do lookback audits in 1981 and 1983 so if the staff was not reduced, it would follow they should have been able to do it in 1983.

Mr. YATES. They haven't done it. They said they haven't had any money for that purpose. It was never presented to our committee.

We are interested in lookback audits. There are various authorities, shall I say, that say that the amount of funds coming from audits is a reflection of the number of auditors.

I saw one figure that said $25 for every dollar that is spent on auditors is returned.

Mr. REGULA. If the Chairman will yield. I noticed in the reconciliation bill yesterday that we passed that they were going to get about $2.8 billion from better audits by the Internal Revenue Service.

That was one of the places they decided they could pick up $2.8 billion.

Mr. **Yates**. They can do it here, too.

Mr. Bettenberg testified last year that there were, I think, $280 million recovered in audits. Now, I have the impression, and subject to your correction, Mr. Bettenberg, that the $280 million is made up in measure of some of the audits that have been conducted by the Inspector General; is that correct?

Mr. **Bettenberg**. That is correct, yes.

Mr. **Yates**. All right. Now——

Mr. **Bettenberg**. I could give you the figure on that, if you would like.

Mr. **Yates**. On the $280 million, or is it split between what you and the Inspector General collected?

Mr. **Bettenberg**. The figure at this point is over $320 million that has been collected from audits over that span of time. Of that amount from the——

Mr. **Yates**. Are these lookback audits or are these some of the collections that have been made as a result of resident auditors with the companies?

Mr. **Bettenberg**. Well, all audits look back. They are not prospective audits. The Inspector General was doing what they called lookback audits, which range from specific kinds of audits on particular leases to extrapolations of those on particular kinds of issues.

Those were then turned over to us for follow-up. In some cases we can bill immediately based on the work they do. In other cases, we had to do further audit work on them. But they are looking back into history with their audits and that is what we do.

We look back into history with our audits and that is what the States and the tribes who are auditing for us do. The sum total of that to date, in terms of actual collections, is about $320 million. Nineteen million dollars of that stems from the lookback audits from the Inspector General.

[**Committee note**.—According to the April, 1986 *Biennial Report of the Federal Royalty Management System,* of the $132.0 million identified in the 35 lookback audits, postaudit adjustments reduced the potential royalties to $120.8 million. . . .

Mr. **Bettenberg**. We are coincidentally, still receiving reports from the Inspector General on their lookback audits.

Mr. **Yates**. How do you account for the letter the Inspector General wrote me then?

Mr. **Bettenberg**. Probably what it reflects is they let their last contract in 1983 or 1984 and the results are just now coming in.

FUNDING FOR AUDITS

Mr. **Yates**. The Inspector General told me he couldn't conduct an audit cycle, he does not have the money to do it. He can't do it with his own staff, he says.

He has got to hire outside auditors to do it. The Inspector General says there is no money in his budget for it; is that correct?

Mr. **Bettenberg**. I don't know what is in his budget.

Mr. **Yates**. Do you have a budget officer here that could verify that?

Mr. **Itteilag**. Mr. Chairman, I talked to Mr. Richards last night about this matter, and insofar as I know, he is correct.

Mr. YATES. All right. Then with respect to the action taken by the House, the House on its own initiative put another $2.5 million into the budget this year for 50 additional auditors and support staff and for the first time, really, the Department of Interior has not protested or taken an appeal from additional funds that the committee has put in.

You have filed with OMB your suggestion which says that, "Based on experience, these additional resources would produce a significant positive return on investment."

"MMS has experienced, during FY 1985 and 1986, a rate of return of seven-to-one when audit collections are considered, and nine-to-one when refund denials are added to audit collections."

Why didn't you ask us for that money when you appeared before me in the first place without the committee having to do it?

I asked you at that time whether you had enough money to carry on your activities. Why didn't you ask us for the 50 auditors without our putting it in?

ADDITIONAL AUDITORS

Mr. BETTENBERG. As a matter of fact, the 50 came from a discussion that I had with staff subsequent to that as we were reviewing our audit results.

Mr. YATES. The staff specifically asked you about whether or not—this was after the hearings were over, weren't they?

Mr. BETTENBERG. Yes.

Mr. YATES. In the hearings when I asked you that question you said the budget that you had was adequate for your purposes.

Mr. BETTENBERG. Yes.

Mr. YATES. Now, we see what you are saying, "Preferred Action: The Department recommends the House amount" rather than the Senate. The Senate struck the money out, I don't know why.

"Even though this represents an increase of $2,869,000 over the Senate's recommended funding level, it is anticipated that approximately $19.9 million in additional royalty revenue would be recovered with the level of resources proposed by the House."

Is one correct in concluding from what you say and hear that if the sum of $2.8 million is invested—$2.5 million is invested, that you will recover approximately $20 million in additional revenue?

Mr. BETTENBERG. That would be our projection.

Mr. YATES. That would be your projection, so that is about eight or nine-to-one, isn't it?

Now, what does that mean? Doesn't that mean that if you have additional auditors you are going to recover additional revenues. And isn't it correct to conclude from that, Mr. Bettenberg, you are not getting your adequate share of royalties?

Last year when I asked you this question you said you had no idea whether—this year, you had no idea as to what the shortages were in collections. As I stated before, the Linowes Commission said it was five to ten percent. Your own Inspector General has said that it is 6.5 percent of uncollected royalties.

Our group, for this very limited survey, says it is three times what the Inspector General said in this area. Yet it is not happening. I don't know how it can happen because your audit system is so bad, VAX and the conversion are so far from being completed that the establishment of an adequate financial base in which to deposit all of your financial information won't permit you to undertake the kind of recovery that the Federal Government should undertake.

You are going to have to have manual audits by auditors. You have got 50 additional auditors doing it.

Why don't you ask for 100 auditors? Would you get the same response if you had 100 auditors, the same ratio of return if you were to get 100 auditors?

Mr. BETTENBERG. We think not. You have covered a lot of ground in your statements and I think that your statements reflect quite a number of misperceptions that I would like to correct.

Mr. YATES. Well, whatever perceptions I have probably came from your testimony before us, but I will be glad to hear what you have to say.

Mr. BETTENBERG. I have tried and I think I have succeeded in being painfully accurate in my testimony.

Mr. YATES. I accept the word "painfully."

Mr. BETTENBERG. In past testimony. The first thing I need to say is that we never claimed that we were getting all of the money that is due and I have testified to that before you.

I have indicated previously that we have a large number of different things that we are working on, many of which have been implemented over the last several years, to get additional money. My recollection of what the Inspector General said with regard to the 6.5 percent was that that is what they found, based on their lookback audits and that their auditors, in fact, looked for problem areas and that was not a figure that could be extrapolated to the universe.

Mr. YATES. Who looks back, your auditors?

Mr. BETTENBERG. Our auditors, their auditors, State auditors. In the investigative report to which you alluded, the conclusion that they draw there, I think, is, frankly, laughable, by coming up with a figure that was tailor-made to be large and then saying if it is applied, then you conclude——

Mr. YATES. I said it was for a very limited area. They spoke about four States and your regional office. I will wait for your reply to that investigative report, but admittedly, as I pointed out, it was that.

But you, yourself, have just in the Department's statement justifying our appropriation, said the return could be on a basis of nine-to-one.

Mr. BETTENBERG. Yes.

UNCOLLECTED ROYALTIES

Mr. YATES. So you know that there is a big amount that is uncollected, a huge amount that is uncollected. In the hundreds of millions.

Mr. BETTENBERG. Some place, certainly, in the hundreds of millions since we have collected $320 million. The suggestion of $30 to $50——

Mr. YATES. Here is the Linowes report. Has this been changed?

"Audits conducted by the private oil and gas companies show that royalties due are normally understated by seven to ten percent. In its 1981 report, GAO said: '[H]undreds of millions of dollars owed the Government may be going uncollected each year.' "

Let me go back to the hearing where you and I were kind of fencing with each other about how well you were doing. On page 726 of part 10 of our hearings, Mr. Bettenberg on the Indians—and their rights—"We are exercising the Secretary's trust responsibility so far as collecting the money is concerned."

Mr. Yates: "Wait a minute. You are collecting the money, but you don't know whether the collections are adequate", and you don't. "The allottees don't know whether the collections are adequate and BIA does not know whether the collections are adequate", and it does not, "and BIA has the responsibility on behalf of the allottees to determine whether the collections are adequate, doesn't it?"

"Are you saying you have that responsibility?"

Mr. Bettenberg: "I think we have that responsibility and we have that responsibility with other Federal lands."

Mr Yates said, "Then for heaven's sake, you are opening up the United States for a tremendous lawsuit because, on the basis of your testimony here this morning, you are saying that you are not really doing an adequate job of knowing whether or not the amounts you have collected are the correct amounts."

Mr. Bettenberg says, "I think what I said is we are getting better and better at that."

Mr. Yates says, "Sure you are. Sure you are getting better and better. It has been four years since the Linowes Commission issued its report. FOGRMA was passed two years ago and you are still struggling to try to get these regulations approved." You still don't have product value regulation. There is no way you are going to get——

Mr. Bettenberg. Actually——

Mr. Yates. Actually what?

PRODUCT VALUE REGULATIONS

Mr. Bettenberg. We have product value regulations.

Mr. Yates. That isn't what your advisory committee tells us. I will tell you what they tell us.

Listen to what the data base committee said. In general—this is your data validation base panel—they concluded, "the problems related to validation of data elements are not truly data base problems but rather the result of larger system-approach related problems. Specifically, poor project management of the design, development and implementation effort has resulted in an overly complex system that will never work well."

Mr. Bettenberg. Mr. Chairman——

Mr. Yates. Let me just finish. "Further, it fails to adequately satisfy the needs of providers and users of information, either internal or external, in spite of the expenditure of substantial funds." And then during your fiscal year 1987 hearing, on page 709, I asked you about the proposed final rule making rule.

Mr. Yates: "When do you anticipate that will take place?"

Mr. Bettenberg: "Let me check. Mr. Hill advises me that it might be as late as this fall before they have final recommendations."

And then September 11, 1986 you write us a letter. We required you to establish product value guidelines and you are appealing that. ". . . it is clear we cannot meet—" I am reading from your letter of September 11, 1986, to me and that will go into the record.

[The information follows:]

United States Department of the Interior
MINERALS MANAGEMENT SERVICE
WASHINGTON, DC 20240

Sent
9-15

In Reply Refer To:
Mail Stop 660

SEP 11 1986

Honorable Sidney Yates
Chairman, Subcommittee on Interior
and Related Agencies
Committee on Appropriations
House of Representatives
Washington, D.C. 20515

Dear Mr. Chairman:

We have reviewed Report 99-714 which accompanies H.R. 5234, the Department of Interior and Related Agencies Appropriation Bill, 1987. The report includes two commentaries relating to Royalty Management which concern me. I would like to share those concerns with you.

On page 40, the report reads ". . . product value guidelines need to be determined expeditiously, so that auditors will have criteria within which they can work. Therefore, product value guidelines are to be completed within 90 days of enactment of this Act." I can assure you that no one is more determined than I am to publish new product value regulations as soon as possible. Nonetheless, because of the impact of product value policy on royalty payors and recipients, the Department of the Interior (Department) made a commitment in January 1986 to solicit the views of the Royalty Management Advisory Committee, an independent review group which reports to the Secretary of the Interior.

We gave our drafts of five different sets of regulations (coal, oil, and gas valuation; gas processing allowances; and transportation allowances) to the Committee in February of this year. The Committee organized working panels to review the regulations and expects to forward its recommendations to the Secretary by November. Thereafter, the Department will need to incorporate the necessary changes and proceed through proposed and final rulemaking.

Because of our commitment to solicit the views of the Advisory Committee (a group which represents States, Indians, and the energy industry), and because of the normal processes through which rulemakings must proceed, it is clear that we cannot meet the time frame in the report, although we are planning to publish final regulations before the end of FY 1987. However, I can assure you that there are currently regulations in place against which our auditors can review royalty payment compliance. Therefore, I suggest that the Conference Report provide us the flexibility to publish these regulations during FY 1987 rather than "within 90 days of enactment" as set forth in your report.

My second concern also relates to language on page 40; ". . . oil companies will only be permitted to take adjustments on their accounts for up to 60 days after production is reported. By taking this action, disruption of audit trails is avoided and the government can be better assured that there is an accurate accounting of royalties due." Although it may seem that the Government's interest is served by refusing to accept adjustments after 60 days, we believe that in fact that will not be the case. Adjustments will continue to take place in company records because many kinds of information (valuations, allowances, reimbursements, changes in unit allocations, etc.) routinely continue to flow into company accounting offices from MMS and other producers, operators, purchasers, processors, and transporters long after the product is sold.

Our reviews of payor adjustments indicate that substantial additional royalties accrue to the Federal Government and other revenue recipients as the result of these adjustments. These additional revenues will still be due the Federal Government under the terms of existing leases and statutes; but, under the terms of the report language, payors would not be allowed to voluntarily report these adjustments and make related payments. This would not only place payors, at least temporarily, in violation of lease terms and statutes, but it would also increase our audit workload. The MMS's auditors will still be tasked with assuring that royalties have been fully and timely paid. To do this, they will need to identify not only underpayments but also overpayments resulting from information and revenue received after the 60-day deadline, to net the two for the sake of equity, all of which is presently performed by payors.

I might also mention that MMS considered establishing a 120-day limit on adjustments four years ago. We published the policy as proposed rulemaking. The public comments were overwhelmingly negative for the reasons cited above, and others, so the proposal was withdrawn. Consequently, I suggest that language be inserted in the Conference Report which supersedes that in the House Report.

I would be happy to discuss these requests further at your convenience.

Sincerely,

Wm D Bettenberg

Director

cc: Honorable James A. McClure
Chairman, Subcommittee on Interior
and Related Agencies
Committee on Appropriations
United States Senate
Washington, D.C. 20510

Mr. YATES. ". . . it is clear that we cannot meet the timeframe in the report, although we are planning to publish final regulations before the end of FY 1987. However, I can assure you that there are currently regulations in place against which our auditors can review royalty payment compliance. Therefore, I suggest that the Conference Report provide us the flexibility to publish these regulations during FY 1987 rather than 'within 90 days of enactment'."

If, in fact, it is just about ready, as you say, why did you have to write this letter to me?

Mr. BETTENBERG. I don't think I said that is just about ready.

Mr. YATES. What did you just say?

Mr. BETTENBERG. I said we have product value regulations. They are in the Code of Federal Regulations. They have been there for years.

Mr. REGULA. Mr. Chairman, would you yield?

Mr. BETTENBERG. We are improving them.

Mr. YATES. All right. Why do you say—I will yield in just a minute, Ralph.

On page 710 of your fiscal year 1987 hearings, Mr. Bettenberg says at that time, too, yes, "[W]e have regulations in place, and those have been in place for some time, and those give us the basic parameters that we use in calculating royalties." That is what you are telling me now. "We have what has grown up as practice . . ." Those aren't product value guidelines that you are working on establishing now. That is what has been in existence for some time.

"We have established starting, I guess, in late 1982, a royalty valuation organization made up of engineers and economists and they issue case-by-case guidance, not broad, general regulation, and they issue case-by-case guidance based on inquiries from state auditors, our auditors and companies."

"In case of transportation allowance, a company is required to come in and get approval on those."

Mr. Yates: "How in the world can a company presently know whether it is complying with what you expect them to do? If they have no guidelines, how can your auditors know whether the company is complying? Isn't it total chaos?"

Mr. Bettenberg: "It is not total chaos."

Mr. Yates: "It is just chaos."

Mr. Bettenberg: "There is a certain amount of chaos out there."

That is Mr. Bettenberg speaking. That isn't Mr. Yates speaking.

Mr. Regula.

Mr. REGULA. Mr. Chairman, I note that you read from a letter to you from Mr. Bettenberg, but you did overlook the first sentence in that paragraph which says "Because of our commitment to solicit the views of the Advisory Committee, and because of the normal processes through which rule making must proceed, it is clear that we cannot meet the time frame in the report."

So I think for the record, it ought to be made clear that they qualified the second part of that paragraph that you just quoted. So you have to take the whole thing and not out of context.

Mr. YATES. I am going to put the letter into the record.

Mr. REGULA. Mr. Chairman, at some point I would like to have them tell me their procedure because you alluded to my comments about how people do it in the private sector on leasing.

COMPUTER SYSTEM

Mr. YATES. I agree. I will do that—no sooner do I read into the record what Mr. Bettenberg told Senator McClure on March 6, 1986 in justifying the 50 auditors—excuse me, the new computer system, not the 50 auditors.

Senator McClure: "As I understand it, the justification for this system in the first place is that you were losing revenues to the Government because of inadequate enforcement capacity."

Mr. Bettenberg: "That's right."

Senator McClure: "So I assume that to a degree you are still losing revenue because you haven't been able to collect it."

Mr. Bettenberg: "No question."

PRIOR HEARINGS

All right. Let's go back to the hearings. I want to bring the main witness in, the Secretary, and in the hearings for fiscal year 1986, Part 8, page 224. Mr. Yates—this is with respect to Secretary Hodel's testimony at the bottom.

"The Minerals Management Service has been cut by $39 million. . . . I must say, after listening to their testimony, that I wonder about the reduction of $39 million. I feel that there is a lot to be done in that service."

Man, that was the understatement of the year. "I think you were Under Secretary of the Department at the time when that was created."

Secretary Hodel: "I was."

Mr. Yates: "And it was created for the purpose of correcting obvious inequities, I was going to say, but it isn't inequities."

Secretary Hodel: "Sure."

Mr. Yates: "Obvious failures and obvious lapse and lax in the supervision of the payment of royalties particularly. It is still going on."

Then I say, "During the testimony yesterday, Mr. Bettenberg testified that the use of mini-computers had not worked out."

I might say parenthetically, we have already spent $50 million on the mini-computers.

"They didn't have the problem under any kind of control. That they have a task force to advise them on what changes to make. But I came away from the hearing with the impression that the team that has been organized to advise either them or you—probably you—on the question, was made up of in-house people rather than being made up of some I would have considered among the outstanding experts in the country."

"They said they were good people. Whether they are or not, I don't know."

"But inasmuch"—this is Mr. Yates still talking—"as there is not only the question of millions of dollars that are involved here, but the possibility of hundreds of millions of dollars being lost here, not only to the Federal Government but the Indian tribes, as well."

I should have included the States.

I wondered why, and I expressed this to Mr. Bettenberg, "I wondered why he wouldn't call in IBM and Xerox and some of the outstanding corporations in the country and ask for their expertise to try to gain a handle on this. They are going to advise you in a little while," Mr. Hodel, "as to what their recommendations are."

"Will you at that time," Mr. Hodel, "be able to act on the recommendations you receive or will you at that time feel constrained to go out to some of the experts in the country and say I don't think this report is adequate.

"I think we have to take another look at it. If you do that again, we have lost three years now in this process."

That is two years ago. "Are we going to lose some more time?"

Secretary Hodel: "Mr. Chairman, would it be appropriate for me to go back in history?"

Mr. Yates: "Sure, because this is a very important subject. It is really one of your most important problems, I think, at the present time."

And Secretary Hodel says this: "I have identified it as the most serious management problem confronting me at the Department of the Interior."

Secretary Hodel continues: "I have asked my Counsellor, who was my Chief Operating Officer with me at the Department of Energy, Earl Gjelde, to become personally familiar with this, knowing I am not going to have the time to manage this personally."

"It is an area I have some knowledge of and ability to deal with. I think our experience at the Department of Energy should help us because at the Department of Energy we had a significant amount of computer activities, which were managed I think, with some considerable success, I believe—although I may have to revise this as I get back into the details—that some of the complexities we dealt with . . ." and so forth.

"In fact, as you know, we did a lot of contracting."

Mr. Yates: "Yes."

Then you continued on with the statement that you had a handful of Federal employees at the Department of Energy who set the policy and oversaw activity. "One of the tremendous advantages of that at DOE was that when performance isn't up to snuff, we can go back out with a request for proposal to another contractor and move forward.

"Historically", you continue, "when I came to the Department of the Interior in 1981, we were confronted with an already serious problem . . . ." that is true, ". . . inadequate collections, inadequate inspections and verifications. We found ourselves with no reliable accounting system. And already a proposal was well down the track for solution. I found myself, as the Under Secretary, with the management responsibility, faced with an either/or. Either we accepted basically the direction that had already been chosen, or place ourselves in a situation where we essentially would have been unable to collect any of the royalties."

"That was the choice. It seemed really like a nonchoice at the time. We made the choice we did—to go forward. It didn't work well."

"We eventually established a Minerals Management Service. Initially, you may recall, I was Chairman of the Minerals Management Committee, which basically was the executive management group. So I am very familiar with this background."

Mr. Yates: "Yes."

"When I come back to the Department now, I find we apparently have not progressed significantly enough to be doing what we ought to be doing."

Mr. Yates: "Have you progressed at all?"

Mr. Regula: "Will the gentleman yield on that?"

As a gentleman, I yielded, and never got an answer.

Mr. **Regula**. What was that?

Mr. **Yates**. Secretary Hodel said we have not progressed significantly enough to be doing what we ought to be doing.

Mr. Yates: "Have you progressed at all."

Mr. Regula: "Will the gentleman yield on that"?

Mr. Yates yielded.

I never got an answer to my question, which I think is a rather significant question.

Mr. **Regula**. Maybe it was a timely intercept.

Mr. **Yates**. All right.

COMPUTER SYSTEM

Now, here we are in 1987, then in the fiscal year 1987 hearing on page 100, "The last word we have . . ." We are talking about when the contractor will be on schedule. This is page 100 of the fiscal year 1987 hearing, Part 8.

Mr. Yates: "Will the computers help?"

Secretary Hodel: "They are supposed to."

Mr. Yates: "When will they be in operation?"

Secretary Hodel: "I think within four or five months now, which is a delay in the schedule from what it was supposed to be. We have had some words with the contractor over that."

Mr. Yates: "The last word we have is they won't be in operation until September of 1986. They are slipping."

Secretary Hodel: "That would be six months."

Mr. Yates: "You are going to check that out, aren't you, and see what happens?"

Secretary Hodel: "We are trying to stay on top of that, because of the importance to us."

MMS COLLECTION BILLING PROCEDURES

All right. Now Mr. Regula comes along and says this—now we are back in 1986, kind of like a movie. Okay?

You are citing from your experience now as a lawyer representing a farmer who has got a well on his farm, and an oil company comes along and says we want to develop that oil well and the farmer says, okay. And you draw the lease or you draw the papers.

Mr. Regula: "Now normally in the private sector there would be a monthly report filed with the landholder, showing the amount of product sold, showing what the revenue was from that product, and indicating what the landowner was to receive, usually 12½ percent in the standard lease."

"Then a check would be sent to that lessor equalling that amount on a monthly basis. Now, here the government is the lessor. Procedurally, how do you collect your revenues from minerals, particularly oil and gas?"

Secretary Hodel: "I don't think I have a sufficiently good grasp of the details of the process to answer that question."

Mr. **Regula**. He does today, though.

Mr. **Yates**. If he does, I will be happy to hear them.

Mr. **Regula**. Mr. Bettenberg will tell us today.

Mr. **Yates**. He will tell us but not Mr. Hodel.

Mr. **Regula**. It is Mr. Bettenberg's responsibility.

Secretary **Hodel**: "I can tell you what my recollections are, but . . . they may have changed."

Mr. Regula: "You know, you are saying that there are underpayments, lack of interest?"

Secretary Hodel: "Yes."

Mr. Regula: "Nonpayments?"

Secretary Hodel: "That's right."

Mr. Regula: "Normally in the private sector, I speak from experience with clients that had mineral receipts from royalty, the lessee paid up front once a month. If there is a bonus, of course, that is paid before the well is drilled. I don't quite understand why there would be such a pattern of delinquency. It sounds as if you bill these leases, rather than to get the lessees sending you the monthly reports and the checks."

Secretary Hodel: "I don't think that is the case. But I think it would be incumbent upon me to ask that the Director of the Minerals Management Service try to respond to those questions at this stage."

This is the answer. I guess we will have to hold ourselves in check until we come back after a vote. Sorry.

[Recess.]

Mr. **Yates**. Mr. Regula is held up somewhere, so we will go back to his testimony a little later.

Mr. Secretary, let me ask you, what ever happened to your personal Secretary-Counselor, Mr. Gjelde? I never did hear about him. Is he around somewhere?

Secretary **Hodel**. Most assuredly. Let me remind you, when I telephoned you a month or so after the hearing in which you indicated in 60 days you hoped we would have a follow-up hearing, I commented I felt we were prepared at that point to give you an update—and I felt good about the update—on where we were headed with the Minerals Management Service. Mr. Gjelde took an active role in participating with the scoping and the completion of the management plan to accomplish what we are trying to accomplish here.

So, when that was——

Mr. **Yates**. Is all this his fault, then?

PROGRESS IN MMS

Secretary **Hodel**. Mr. Chairman, I hope eventually we will have an opportunity to describe a somewhat different perspective on the situation than what you have described here this morning, not because we, I think, are overlooking the problem, but because I think we have tried to take an extremely complex area and get it under control, and we have not achieved that yet, and you are absolutely right about that.

I don't quarrel with the concern that you have, but I believe that, in fact, if I can characterize broadly what is happening——

Mr. YATES. Tell us broadly and then be specific.

Secretary HODEL. As I perceive, we are on the right course. We have not moved as rapidly as we wanted to move, and should certainly have hoped to be able to move, because it has turned out these problems are far more complex and more difficult to computerize and get up to speed than certainly our contractor anticipated, and than we anticipated. But the system is, in fact, largely working.

It has problems at the margin, but the margin is getting smaller. Now, that margin, still, with the dollars we are talking about, is more than enough to attract your interest and our interest and justify aggressive pursuit. I don't dispute that.

But I do think that the case that Mr. Bettenberg can make, if we will take a look at the whole process, is that we have made real strides; and we have a way to go, but we have come a long way. For instance, with regard to the computers, as you know we have a contract dispute with Martin Marietta.

Mr. YATES. I know that.

MARTIN MARIETTA CONTRACT

Secretary HODEL. Inevitably, in a contract where there are substantial additional expenditures made by the contractor, his assertion is that it was our fault; and our assertion will be that it is his fault. We will have an argument about that. To date, I am advised by Mr. Bettenberg, the product has been a good product.

We do still believe that that contractor is going to provide us with the computer operations that we really have to have. It is a relational data base. Because what happens, as I understand this—and we clearly should get more detailed testimony from Mr. Bettenberg—the basic problem is, on any given lease, we have a product. The product is measured. And we get estimated or temporary figures as to what the amount was. That is an adjusted figure later.

We make a payment based on estimates. We come back with an adjusted figure.

Now, every royalty that was paid, based on the estimate, has to be adjusted. That is where a relational data base comes in so very handy, because if you adjust one figure it automatically will readjust, and we can make the necessary adjusted payment. I am told this is not uncommon in the oil industry, as well. Then we add to the complexities that you have different qualities of crude oil. You have different natural gas liquids. All come in at different valuations.

Truthfully, as with the Internal Revenue Service that you talked about earlier, most of us, I hope, pay the taxes we know we owe. But if we have a doubt about an item, it is not uncommon for the taxpayer to submit his tax return taking the most favorable interpretation to his position. Then the IRS has to come back and say, whoa, we are not going to permit that. This, I am sure, is true of some of these filings that have been made with us.

In fact, if you look at the collections in the Inspector General's report and our own audit reports from MMS, we find that out of a claim of $150 million, that we adjusted downward after the first go-round in most instances, because we take a look and say, okay, your argument is good there. Then we will collect an amount, and then we may have an amount that is put into litigation because they strongly resist that. That is just not properly interpreted.

So, with this complex system, there is no point in our putting together a computer system which isn't going to work. We think it can work. We still believe—and I understand we have no indication from Martin Marietta that they don't believe—in the end this process can work.

Mr. YATES. They don't see the end, though. They have told us that they don't know when it is going to be completed now. They have told our investigative staff verbally that they can't make sense out of, in great measure, the requests they get.

Of course, they are in a contest with MMS because MMS is penalizing them a certain amount every day.

Secretary HODEL. $5,000 a day.

Mr. YATES. I think that ought to be in the record, too, to show perhaps Martin Marietta's opinion may be influenced by that in some respect.

Martin Marietta will come in at some later date, and you will probably forget about that. Because if you can get some kind of agreement, perhaps it is worth it, if you can get any kind of a computer system out of this thing. As of now, you don't have a computer system. You are working with VAX, are you not?

Secretary HODEL. Yes.

Mr. YATES. And you know that VAX is inadequate, don't you?

Secretary HODEL. Yes. That is why we have gone to a new system.

Mr. YATES. We don't know when you are going to get this one, do we?

Secretary HODEL. Perhaps I should ask Mr. Bettenberg to respond a bit more definitively. I didn't think it was as open-ended as their quotation in the letter may suggest.

Mr. YATES. Okay.

Mr. Bettenberg, how do you interpret that letter?

Mr. BETTENBERG. Well, I guess it is consistent with something that Martin told me day before yesterday, which was the first time, in fact, that I heard that particular argument or question from them. We had thought that it was fairly cut and dry.

What we are down to at this point is, they have developed a computer system. They are testing a computer system. They have taken a long time in getting to this point, but they have tested individual programs and work packages. They have done some of what we called integration testing, which begins to run strings of programs together with test data, and at this point they are using the test data that we had to actually run the full system.

They have run month one. They found lots of problems. That is normal in this kind of testing. We presume that they are in the process of correcting those, although they have not, to date, shown us the final results of the correction. They are, at this point, running month four.

We had originally suggested to them—and my recollection is that some time ago there was basic agreement—that an appropriate test on their part would be to run data for seven months.

Mr. YATES. Well, where does this lead, though? Day before yesterday, you talked to Martin Marietta, and Martin Marietta told you something different than what they told the committee.

Do they have a completion date?

Mr. BETTENBERG. No, they don't have a completion date.

Mr. YATES. All right. They are going to have certain test runs, but they still don't know when it is going to be completed, do they, actually?

Secretary HODEL. Mr. Chairman, I think what Mr. Bettenberg was about to conclude was that there may be a disagreement over the amount of tests that we will require before we will accept the system from them, and they may very well be saying, therefore, they don't know how long it is going to be. But what they are saying to us is, they are now in test of their system and they are working out—they think, they allege, tell us—the problems on that system.

If I have not said that correctly, correct the record for it.

Mr. YATES. That is just one of the points they raise in their letter, Mr. Secretary. You have stated that correctly, perhaps. But they also say this: "The poor condition of the Test Data environments supplied by Minerals Management Service make it difficult to accurately schedule."

Now, that isn't what Mr. Bettenberg was going to tell us. They don't say that they are getting good materials from MMS.

Secretary HODEL. Mr. Chairman, I think it is fair to recognize, as you did earlier, that this is a contract dispute. I would expect Martin Marietta to protect every legitimate claim that they may have to justify the delay in the overrun, and I would hope we will do the same.

For instance, you suggest we might forgive this claim. I am not prepared to say we will forgive the claim at this stage.

Mr. YATES. Even assuming that is true, can you tell the committee when your completion schedule will be?

You cannot?

Mr. BETTENBERG. It is Martin's completion schedule—not ours, Mr. Chairman.

Mr. YATES. What shall the committee do? Ask Martin Marietta when they will complete it? We have asked them, and they say there is no completion date. So, as far as this committee knows at the present time, this will go on and on and on without getting a schedule.

We have already spent—how much have we spent on the new computers? We spent $50 million on VAX, and you have a new contract for $32 million. So you have already spent $82 million on computer systems, and you don't know where the computer systems—when they are going to be completed.

Even when the $32 million is completed, you still have 300 enhancements that have to be worked into the computer system, 300 enhancements, special items, and disagreements that have to be worked into the system somewhere.

So, when you do have a completion schedule, after you are through with that completion date, you have 300 enhancements that still have to be taken into consideration in the schedule. So you are years away.

CONTRACTOR OPERATED APPROACH

Now, in your fiscal year 1986 testimony, Mr. Secretary, shall I use the word "anguish"—or what to do with this apparently insuperable problem, you said you might go to a contractor, an outside contractor, for the purpose of doing this kind of work for you. I am not talking about the computers. I am talking about handling the whole business of collections and payments out, the work that MMS is required to do under the law.

But you were thinking at that time that perhaps it would be—because of MMS—let me discretely say because of the multifarious nature of the problems that MMS has—this is not MMS's sole responsibility—because of the many problems it has, perhaps some outsider might be the one. This is what you say on page 231 of Part 8 of the fiscal year 1986 hearings, when you talked about the Geological Survey.

"It was my conclusion, obviously Secretary Watt shared it, that the collection of royalties was really a very secondary concern to scientists who were trying to gather information and data about the geological condition of the world. That was why we thought it had to be separately established."

"But what we did was to take the entire organization that then existed and simply transferred it over. We did not obtain new, professional, collection-oriented, and inspection-oriented management. That could have been a serious mistake in the light of the current situation."

I wonder whether you still think so. "It seems to me before we commit to a new massive computer program, I would like the ability to come back to the committee and suggest, if it seems appropriate, that we would like to explore the contractor-operated approach, because we have organizations in this country which have proven themselves to be enormously successful at processing data, collecting it the way it ought to be collected and moving it as it ought to be moved."

What happened to that?

SYSTEM X

Secretary Hodel. That was what we would have been prepared to discuss, I guess a year and a half ago now, when I telephoned and suggested we were prepared to follow up with the follow-on hearing that you requested. Because, as Mr. Gjelde got into it, my recollection—which I would have to refresh to be positive of—but my recollection is we found ourselves in a situation where, if we had decided at the point in the spring of 1985 to stop the process then in place, and to go out to hire a new contractor with the procurement regulation that we have to apply, quite properly as a public agency, we would have put a multi-month glitch at least, and possibly a several years' glitch, and be back at a starting point. Somebody new would have to come in.

The conclusion was we could scope the Martin Marietta arrangement and the contract to make it work. Particularly, if you will recall, we were testifying at that point to a much earlier completion date. We still hadn't, at that point, seen the kind of complexities and difficulties that have since developed as far as getting the computer up and running.

Mr. Yates. All right. Go ahead, sir.

Secretary Hodel. So, again, it was a conclusion at that time that we should continue with the Martin Marietta contract. And I really cannot say yet, Mr. Chairman, that in retrospect it would be a mistake, because we have made progress.

Regarding the 300 items you have talked about, we consciously have frozen the data system, as I understand it, so that we don't compound the complexity. We are saying to Martin Marietta, complete the process that you began to complete. When it is up and running, we have modification capability. We will then do enhancements. But the bulk of the system will be in place and running.

Mr. Yates. Well, you talked about the extra hearing last year, and you might have mentioned the outside contractor at that time. In your report to Congress October, 1985, which would have been about the time of the hearing, Implementation Status Report on the Management Action Plan for the Royalty Management Program, Minerals Management Service, U.S. Department of Interior, on page 8, you said this:

DEPARTMENT STUDY

"Early next year, the Department's Assistant Secretary for Policy, Budget and Administration, will also commence a detailed study of the feasibility for a government-owned contractor-operated (GOCO) approach to handling certain royalty management activities. The study is scheduled for completion in 10 months."

The study hasn't been started yet. That is a great idea, to look at the possibility of government-owned, contractor-operated operation for functions of MMS.

What happened to your department's—who is your department's Assistant Secretary for Policy, Budget and Administration?

Secretary Hodel. Mr. Riso.

Mr. Yates. Mr. Riso.

In October 1985, you were going to have a study completed in 10 months. The information the committee has is that hasn't been started yet; is that correct?

Mr. Riso. That is right, sir, yes.

Secretary Hodel. While we are on that subject, Mr. Chairman, I need to ask Mr. Riso if he would expand on that. That was a MMS report, was it not?

Mr. Yates. Yes, it was. That is you.

Secretary Hodel. I would just like to have on the record the status of the communications between MMS and the Assistant Secretary to make sure we are not leaving the wrong impression with the committee, to see what the plans are for the PBA study.

Mr. Yates. How often do you talk to Mr. Bettenberg?

Mr. Riso. Several times a week. Sometimes once a month.

Mr. Yates. All right.

Secretary HODEL. Could you advise the Chairman as to what the status is of your thinking on that study?

Mr. RISO. I'll be glad to. The same question was raised that you began the hearing with—whether there were two functions within MMS which basically conflict with one another. This raised the question as to whether the collection function might not be placed somewhere else, either within the government or outside the government.

Mr. YATES. That is the study that was contemplated to be made.

Mr. RISO. That is right. We began by scoping the question that needed to be addressed. We looked at whether a study of this size was too big a chunk to bite off in 10 months.

Mr. YATES. You say a study was completed?

Mr. RISO. No, sir. We raised the question of whether a study could be completed within that 10-month period.

As we talked about the schedule with the Assistant Secretary for Land and Minerals Management, he wondered whether we might save time by taking a different kind of function that dealt with the collection of fees and the inspection process within his area and use that as a test case on contracting out the system before we attempted this larger study within the MMS function. We have scoped that review out and are beginning to figure out who would want this kind of business and where organizationally would you place it.

Mr. YATES. It has been a year since you have been contemplating that. How many more years before you actually start it?

Mr. RISO. It is our intent within the coming fiscal year to have resolved our questions. One, complete this initial test case that the Assistant Secretary for Land and Minerals Management felt might be a good test as to whether this kind of function could be contracted out; two——

Mr. YATES. You haven't decided yet? You have a preliminary study to the main study.

Mr. RISO. Yes, determine the issues that have to be addressed, and is this doable. We are scoping this out.

Mr. YATES. Who is going to do the study? Are you or Mr. Bettenberg going to be doing that study?

Mr. RISO. It will be a mixed staff—Bill's staff, some people from PBA—within the department.

Mr. YATES. I think you have already answered the question, really. You can have your study, but if Mr. Bettenberg's staff is going to be working on that, it is not going to be working on the job the Congress gave it under FOGRMA. It is going to have to be working on that study, so you are taking away some of his people from the collection of royalties immediately, aren't you?

Mr. RISO. We have to deal with numbers of people here. We are not talking about 2,000 people.

Mr. YATES. Lesser numbers of people under the Gramm-Rudman budget.

Mr. RISO. There is another question, sir.

Mr. YATES. Okay.

MOVING COLLECTIONS OUT OF MMS

Mr. Riso. One of the issues that you have raised and we are raising that we will address in this study is whether this activity should be moved out of MMS——

Mr. Yates. Right.

What do you think now? You have had a year to think about that possibility. Why do you have to study it? You know what MMS is doing now, don't you? You know that it is not doing the job properly. What is there to do? Why don't you move it to another agency? I don't know whether IRS would do it better. I am sure IRS couldn't do it worse, because IRS is a collection agency.

Mr. Riso. That is right.

Mr. Yates. IRS has got clout. You have got clout under the Act that you don't use at all. You are just starting to use them. You are anxious to get a word in. Okay.

Mr. Riso. I don't want you to reach a conclusion before I have had the opportunity to effect it.

Mr. Yates. All right.

Mr. Riso. There are two basic questions. That is, is this an appropriate function for MMS? I have got reservations about this and—whatever these reservations were have been increased by the conversation this morning about the length of the history of this problem.

The second consideration, however, is that irrespective of where you put the function, you have to have a working system. The MMS system has had a problem with Martin Marietta that we have been talking about; the delivery date has consistently slipped.

We hear this morning that perhaps no one is ready to commit to a "delivery date." Therefore, as you have conversations with other agencies within the government or outside of the government about running a system, the question is what are they being asked to run? We have talked about a complex system. Royalty management, irrespective of whether it is in the government, is a complex system.

[Committee note.—Subsequent to the hearing the Department provided the following information:]

Alternative Approaches to Collections

The Assistant Secretary—Policy, Budget and Administration has been looking into the question of whether or not it is practical to contract for collections operations of the Minerals Management Service or instead to move this function to another Government agency with more experience in collecting funds. Some of the subsidiary questions being addressed include which agencies or private companies might be interested in conducting the operation, what inducements or incentives have to be available, and what opposition is likely within the Government or outside should such a shift in responsibility occur. The question has also been raised as to whether a study of this size is too complex to complete within 10 months and whether the analysis would be more useful once the new computer system is up and running.

The Assistant Secretary—Policy, Budget and Administration has discussed the schedule with the Assistant Secretary—Land and Minerals Management particularly with respect to the effect of delays in implementing the new system. In this respect, a question was also raised as to whether time might be saved by studying a different, but similar, function that also involved the collection of fees and inspections and use that as a test case in addressing questions concerning contracting out before attempting a larger study concerning the Minerals Management Service.

The Department is primarily interested in knowing who could perform such a function, under what conditions and incentives, and whether such conditions would be acceptable.

Mr. **Yates**. It has been discovered it is too complex for MMS. We have just touched the surface of the problems that MMS—sounds like "mess," doesn't it—is confronting. We hope we have enough time to go into those, as well.

MMS, in my judgment, just doesn't have the capacity, let alone—we are not going to talk about ability—doesn't have the capacity to handle all of the ramifications of this problem in order to protect the rights of the Federal Government, the States, and the Indian people, to what is their proper royalty, proper share of the royalties that are due. I will go into that in a few minutes.

You want to make the study now that you wanted to make 10 years ago. You want to make it. We will give you the money for it in the conference report. I think it is too late for it, actually. I think it is too late. The Secretary should have done it when he had this hearing. He decided, as we pointed out, to go with MMS on this.

In retrospect—and perhaps it is unfair—it wasn't a decision to be made. But now we are at kind of a watershed position, knowing how MMS is operating, knowing what is involved here—and perhaps I should say this type of approach, until the hearing is near completion—what should we do at the present time? Should we wait a year for the Assistant Secretary's study, in the meantime losing all the royalties? Because you are not going to have an adequate number of audits.

You don't have enough people for the audits. You are not going to look back—you have got what Mr. Boldt describes in the hearing as a statute of limitations of six years. I don't think there is a statute of limitations of six years. There is a provision in the statute which requires your companies to keep their records for six years. But that doesn't limit you except in not having the records available, as I understand the purpose of the law.

PROBLEMS OF STATES AND TRIBES

But, regardless of that, let me just point out what the tribes are saying. The State of Wyoming, they are not happy with the job that MMS is doing. Here is a letter from the Wyoming State Auditor, dated September 23, 1986. I will put the letter into the record and give you a copy of it. This is signed by Joseph Mania, Member, State Tribal Royalty Audit Committee.

"Based on the above discussion, it appears to this committee that the MMS is not enforcing its own regulations, as well as not complying with them, i.e. EOP and late disbursement interest accrual problems. As a result, the audit and collection efforts of the states and tribes have been hindered. We would appreciate any effort you can put forth to resolve these problems." That is Wyoming.

[The letter follows:]

THE STATE OF WYOMING

Wyoming State Auditor

STATE CAPITOL BUILDING CHEYENNE, WYOMING 82002

JAMES B. GRIFFITH
STATE AUDITOR

(307) 777-7831

[illegible]

September [illegible], 1986

The Honorable Sidney R. Yates
Committee on Appropriations
Box 308, Rayburn House Office Building
Washington, D.C. 20515

Dear Mr. Yates:

At the September 17-19, 1986 meeting of the State Tribal Royalty Audit Committee (STRAC), several issues arose concerning compliance by the Minerals Management Service (MMS) with various sections of the Federal Oil and Gas Royalty Management Act of 1982 (FOGRMA). The states and tribes participating in delegated and cooperative audit agreements with the MMS have concerns regarding the impact that a lack of compliance may have on their audit and collection activities.

Concerning Section 105(a), "Explanation of Payments" (EOP), FOGRMA states in part, "there shall be provided, together with such payment,... production amounts, the royalty rate, unit value,...Indian allottee. The EOP report that is sent to the states and tribes summarizes or rolls-up certain data items from the MMS form 2014 submitted by the royalty payors. Consequently, it is not possible to obtain a correct royalty rate or unit value at the individual revenue source level of the lease. Also, sales rather than production amounts are submitted on the 2014.

Another area of concern is the issue of interest accrued on the late disbursement of royalties. Section 111(b) of FOGRMA states in part, " any payment made by the Secretary to a state under Section 35 of the Mineral Lands Leasing Act of 1920 (30 U.S.C. 191) and any other payment made by the Secretary to a state from any oil and gas royalty received by the Secretary which is not paid by the date required under section 35 shall include an interest charge computed at the rate applicable under section 6621 of the Internal Revenue Code of 1954." 30 CFR 219.101(a) specifically addresses the issue of royalty and related monies that are placed in a suspense account until resolution of matters that will allow distribution and disbursement. Current MMS practice does not provide for late disbursement interest accrual for cases where royalties are paid to the MMS but are not disbursed for several months because the 2014's were not submitted by the payor. The above cited CFR states that "such monies not disbursed by the last business day of the month following receipt by the MMS shall accrue interest until paid." (emphasis added)

A final concern addresses the failure of the MMS to assess penalties for late reporting and incorrect reporting on audits conducted by the states. 30 CFR 218.56(a) and (b) provides for the assessment of a $10 per day penalty, each for late and incorrect reporting. These penalties are provided to assure compliance by the payors. The fact that royalty payors are allowed, for example, to submit 2014's months after the royalty itself has been paid has brought financial harm to various states as explained in the previous paragraph. Assessment of penalties would provide incentive for payors to submit correct and timely reports.

Based on the above discussion, it appears to this committee that the MMS is not enforcing its own regulations as well as not complying with law, i.e. EOP and late disbursement interest accrual problems. As a result, the audit and collection efforts of the states and tribes have been hindered. We would appreciate any effort that you could put forth to resolve these problems.

Please do not hesitate to call me at (303) 231-2842 or FTS [illegible]-2842 if you have any questions.

Sincerely,

Joseph [illegible], Member
State/Tribal Royalty
Audit Committee

Mr. YATES. Here is a letter from the State Auditor of the State of North Dakota. I quote from that. This letter may go into the record at this point, too.

"It appears that the data base contains many incorrect data elements and is also lacking some information altogether, such as well information for many leases . . . We feel that without the implementation of PAAS for all onshore oil and gas leases . . ."—all we have got with PAAS is a pilot study going on at the present time for a relatively few leases out of the 25,000 you have— ". . . AFS," he says, "is nothing more than a receipts and disbursements system with no reconciliation of cash . . . PAAS operates on well data and therefore would be extremely beneficial as an audit tool to the states, tribes, and MMS."

[The letter follows:]

STATE AUDITOR
ROBERT W. PETERSON

STATE OF NORTH DAKOTA
Office of the State Auditor
State Capitol • Phone (701) 224-2241
Bismarck, North Dakota 58505

September 23, 1986

The Honorable Sidney R. Yates
Committee on Appropriations
Box 308, Rayburn House Office Building
Washington, D.C. 20515

Dear Mr. Yates:

On September 17-19, 1986, members of the State/Tribal Royalty Audit Committee met in Lakewood, Co. with MMS and BLM representatives to discuss problems related to our audit work.

One problem common to all states and tribes is our concern about the validity of the Auditing and Financial System (AFS) data base. It appears that the data base contains many incorrect data elements and is also lacking some information altogether, such as well information for many leases. Payor Informations Forms (PIF's) submitted by payor companies are often incorrect and sent in late which is evident by the amount of rejected royalty lines. If MMS would enforce the penalty provisions under Section 109 of the Federal Oil and Gas Royalty Management Act of 1982, we believe the payor companies would be more inclined to comply with reporting regulations.

The State/Tribal Royalty Audit Committee has also expressed concerns about the status of the Production Accounting and Auditing System (PAAS). PAAS is currently operating in a pilot phase with only a handful of state and tribal leases in this pilot project. We feel that without the implementation of PAAS for all onshore oil and gas leases, AFS is nothing more than a receipts and disbursements system with no reconciliation of cash. In addition, there will be no accounting of production from state and tribal mineral leases upon which royalties are calculated and paid. PAAS operates on well data and therefore would be extremely beneficial as an audit tool to the states, tribes, and MMS. The implementation of PAAS is essential to properly account for royalty revenues due to the states, tribes, and federal government.

Sincerely,

Robert J. Kronebusch
Robert J. Kronebusch
AFS Data Base/PAAS Subcommittee
State/Tribal Royalty Audit Committee

Mr. YATES. If you have a private study on that, as well. That can go into the record at this point.

Then you have the Southern Ute Indian Tribal Council, in a letter to me dated September 23, 1986 signed by Karen Anderson, State-Tribal Royalty Audit Committee, and Chris Baker, Chairman, Southern Ute Indian Tribal Council, they say this: "One of the valuation methodologies allowed by 30 CFR 206.103 provides for the use of the highest price paid for a part of the production from the field. To insure that the best interests of the Tribe are served and that the Tribe receives maximum benefit from its mineral resources, the highest price paid for any similar quality tribal gas sold in the field should be used as the royalty basis if other regulations or rules do not allow for a value which is greater."

"The Minerals Management Service, however, to the extent that records have been made available to the Tribe, has not in any case (or in general) singly applied this valuation methodology to tribal minerals."

This may go into the record at this point.

[The letter follows:]

SOUTHERN UTE INDIAN TRIBAL COUNCIL

Tribal Affairs Building
POST OFFICE BOX 737
IGNACIO, COLORADO 81137
303-563-4525

CHRIS A. BAKER, CHAIRMAN
CLEMENT J. FROST, VICE CHAIRMAN
LEONARD C. BURCH, COUNCIL MEMBER
EDWARD BOX, SR., COUNCIL MEMBER
VIDA B. PEABODY, COUNCIL MEMBER
GUY PINNECOOSE, JR., COUNCIL MEMBER
LILLIAN I SEIBEL, COUNCIL MEMBER

September 23, 1986

Chairman Sidney R. Yates
Appropriations Committee
Sub-Committee on Interior and Related Agencies
Box 308 Rayburn House Office Building
Washington, D.C. 20515

Dear Chairman Yates:

This letter is presented to you for your consideration and review and as a statement of position in part of the State-Tribal Royalty Audit Committee regarding the efforts of the Department of the Interior, specifically the Minerals Management Service, to comply with and carry out the mandates of the Federal Oil and Gas Royalty Management Act and other precedent statutes and regulations.

In the interest of brevity this statement shall address the single issue of the valuation of natural gas using the majority portion methodology or alternate methodology allowed by 30 CFR §206.103. The aforementioned methodologies shall be discussed as they might apply to the valuation of hydrocarbon minerals removed from Southern Ute tribal lands.

All Southern Ute tribal leases issued pursuant to the Indian Mineral Leasing Act of 1938 contain the following language:

> During the period of supervision, "value" for the purposes hereof may, in the discretion of the Secretary, be calculated on the highest price paid or offered (whether calculated on the basis of short or actual volume) at the time of production for the major portion of the oil of the same gravity, and gas, and/or natural gasoline, and/or all other hydrocarbon

> substances produced and sold from the field where the leased lands are situated . . ..

The majority portion analysis as defined by the Department of the Interior involves identifying the prices paid for all the gas sold in the field on a monthly basis and computing a median price for the volumes which comprise the higher priced half of total production from the field.

When a majority portion analysis for royalty valuation purposes is not possible, 30 CFR §206.103 provides alternate valuation methodologies which the Secretary or his delegate may apply singly or in any combination to arrive at a reasonable value for the product. Since approximately 44% of the total production from the Ignacio-Blanco field (the primary producing field within reservation boundaries containing more than 1,000 wells) is sold from private non-Indian leases, the prices paid for all gas sold from the field cannot be identified and the majority portion analysis cannot be applied. In such a case, the application of the valuation methodology cited in 30 CFR §206.103 which would yield the maximum benefit to the Tribe is the only option available to the Secretary under his fiduciary role as trustee.

One of the valuation methodologies allowed by 30 CFR §206.103 provides for the use of the highest price paid for a part of the production from the field. To insure that the best interests of the Tribe are served and that the Tribe receives maximum benefit from its mineral resources, the highest price paid for any similar quality tribal gas sold in the field should be used as the royalty basis if other regulations or rules do not allow for a value which is greater. The Minerals Management Service, however, to the extent that records have been made available to the Tribe, has not in any case (or in general) singly applied this valuation methodology to tribal minerals.

Under the Gas Valuation Regulations proposed by the Minerals Management Service, §206.103 of 30 CFR would be deleted in its entirety. The language in the MMS proposed valuation regulations does not specifically address either the majority portion of the highest field price methodologies. The gas valuation regulations currently being developed by the Gas Valuation Panel of the Royalty Management Advisory Committee provide even less protection to the value of tribal mineral resources.

While the Minerals Management Service through the Office of State and Tribal Program Support has provided a valuable audit service to the Tribe, the MMS valuation policies both past and proposed do not fulfill Interior's statutory obligation to insure maximum benefit and protection to the Tribe guaranteed by the Indian Mineral Leasing Act and the Federal Oil and Gas Royalty Management Act.

Yates/State-Tribal Royalty Audit Committee
Page 3
September 23, 1986

It is the hope of the State-Tribal Royalty Audit Committee, particularly the tribal representatives on the Committee, that this statement will assist you in your evaluation of the Royalty Management Program of the Department of the Interior.

Respectfully submitted,

Karen H Anderson

Karen H. Anderson
State-Tribal Royalty Audit Committee

Chris A. Baker

Chris A. Baker, Chairman
Southern Ute Indian Tribal Council

KHA:sls

Mr. YATES. Here is Oklahoma. This is a letter dated September 23, 1986, signed by Roger Q. Melson, Chairman of the Subcommittee on Take-or-Pay of the State Tribal Royalty Audit Committee. He says that, Sun Audit is just one example of the hesitancy to enforce FOGRMA. "Until the MMS decides to aggressively enforce their rules and regulations, companies will continue to deny us the data we must have to adequately complete the job at hand—ensure the proper payment and reporting of mineral royalties due from Federal and Indian leases."

[The information follows:]

1907

STATE OF OKLAHOMA
OFFICE OF THE AUDITOR AND INSPECTOR
OKLAHOMA CITY

CLIFTON SCOTT
State Auditor and Inspector

100 State Capitol
Oklahoma City, OK 73105
405/521-3495

September 23, 1986

Honorable Sidney R. Yates, Chairman
Committee on Appropriations
Subcommittee on Interior and Related
Agencies
B308 Rayburn House Building
Washington, D.C. 20515

Dear Chairman Yates:

On February 27, 1985 the Oklahoma State Auditor and Inspector received a delegation of authority from the United States Department of the Interior's Minerals Management Service (MMS) to perform audits and related investigations of Federal oil and gas leases located in the State of Oklahoma in accordance with Section 205 of the Federal Oil and Gas Royalty Management Act (FOGRMA) of 1982. In the course of performing these audits, the State of Oklahoma as well as our sister states and Indian Tribal Units which have similar delegations of authority, have encountered several issues which we feel have not been adequately addressed by the MMS. This letter addresses one of those issues; "take-or-pay" receipts and settlements. A "take-or-pay" contract is defined as a gas purchase contract that requires the purchaser to take a minimum annual volume of gas that the producer has available for delivery, or to pay for that minimum amount even if not taken.

The Department of Interior (DOI) and MMS have adopted the position that royalties are due on the "take-or-pay" provisions of gas sales contracts immediately upon the producer's receipt of any payments under the "take-or-pay" provisions. In response to a request for the DOI's position on this issue, the Associate Solicitor for Audit and Investigation of the U.S. Department of the Interior noted that departmental policy (as set forth in the Minerals Management Service Royalty Management Program Payor Handbook) clearly requires payment of a royalty on "take-or-pay" receipts. Such royalties are processed by the MMS as advance credits against future royalties due.

One of the companies selected for audit during fiscal year 1986 by the Oklahoma Auditor and Inspector was Sun Company, Inc. Of Sun Company, Inc.'s approximately 100,000 onshore leases, 548 are Federal or Indian leases. Of these Federal and Indian leases, the majority are located in the State of Oklahoma.

During the course of our examination, we encountered several circumstances which constituted a limitation on the scope of our procedures. We requested numerous documents and information from Sun to quantify potential royalty underpayments resulting from "take-or-pay" payments and "take-or-pay" settlements, which Sun refused to supply on the premise that royalties are not due on "take-or-pay" payment or settlement amounts. Further, Sun stated that they believed such information was outside the scope of the audit, and it would not be provided. As a result of not receiving the requested documents and information, we were unable to complete all procedures related to these areas outlined in our audit program.

The Oklahoma State Auditor and Inspector's Office contacted officials within the MMS to advise them of Sun Company, Inc.'s denial to provide the requested data. The MMS stated, "there are several significant "take-or-pay" cases in litigation and they (MMS) were not inclined to pursue additional cases at this time." We feel this to be unacceptable. There are several avenues available to the MMS to force compliance with their rules and regulations, including the imposition of civil and criminal penalties as provided in Section 109 and Section 110 of the Federal Oil and Gas Royalty Management Act of 1982.

The Sun audit is just one example of the hesitancy to enforce FOGRMA by the MMS. Until the MMS decides to aggressively enforce their rules and regulations, companies will continue to deny us the data we must have to adequately complete the job at hand--ensure the proper payment and reporting of mineral royalties due from Federal and Indian leases.

Respectfully yours,

STATE TRIBAL ROYALTY AUDIT COMMITTEE

Roger Q. Melson, Jr., Chairman
Subcommittee on Take-or-Pay

RQM:aw
cc: Karen Anderson, Southern Ute Tribe, Colorado
Steve Bensen, North Dakota State Auditor's Office
Larry Biggio, Wyoming State Auditor's Office
George Bowman, Utah State Tax Commission
Bob Fees, California State Controller's Office
Mike Greene, Office of Colorado State Auditor
Terry Lines, Office of Auditor General-Navajo Nation
Akhtar Zaman, Office of Auditor General-Navajo Nation
Don Hoffman, Department of Revenue, Montana
Donna Woods, Dept. of Natural Resources, Alaska

Mr. **Yates**. That raises another point in my mind that I read in the investigative report, and that was the Inspector General—this was several years ago—the Inspector General was doing a lookback audit of Chevron. Chevron refused to make available its records to the Inspector General; wouldn't do it. Okay. Then MMS took it over. Chevron: "Yes, we will make our records available some time." I don't know how long it took.

There were no penalties. The Act says, if your lessees refuse to make their records available for audits, they are subject to penalties.

Mr. **Bettenberg**. We are doing that. This is three or four years ago.

Mr. **Yates**. Did you apply penalties?

Mr. **Bettenberg**. Not in that case. For a reason.

Mr. **Yates**. What was the reason?

Mr. **Bettenberg**. The reason is that our law says that we have to give the company notice, and if they don't comply within a certain number of days, then we can assess them a penalty. We gave them—we told them we needed the records, and they gave us the records. So there was no reason to fine them and no legal basis for fining them.

We have done that in other cases, but not in the Chevron case because they complied.

Mr. **Yates**. Well, you come to a different conclusion than the Inspector General, then. He says they didn't give him the records.

Mr. **Bettenberg**. They didn't give the Inspector General their records.

Mr. **Yates**. Is it because the Inspector General didn't request them properly?

Mr. **Bettenberg**. I don't know. The Inspector General has subpoena authority. But, when they turned the case over to us, we requested the records and they gave us the records.

OIL PRICING IN CALIFORNIA

Mr. **Yates**. All right. Let me raise a problem with California now. I think the Secretary, with your background at Bonneville, you know about oil pricing and various kinds of pricing.

This is a letter I received from a law firm which has an interest, I may say—I think they may have an antitrust case against some of the companies that are involved—but, nevertheless, I read this to you in order to show a problem here.

We have been talking about inadequate collections. We have been talking about not having the ability, because of an inadequate financial system and an insufficient number of auditors, perhaps, to make a number of audits, to bring in, not only to assure a greater amount of funds for the Federal Government, the States and the Indian tribes, but there is another question here.

Suppose the oil companies underprice their oil. The royalties will be underpriced then, won't they, underestimated, if that happens? Do you know whether that is happening in California, Mr. Secretary?

Secretary **Hodel**. No, I do not. But we have discussed the problem of arm's length versus non-arm's length transactions. This has risen in my recollection, primarily with regard to natural gas contracts, where there has been a restriction on the price and we have had a regulation which has said we will collect royalties on the allowable FERC price as distinguished from what the contract price is and it is my view that that is not an appropriate rule.

The rule should be that we collect on the contract price if it is an arm's length contract, but if it is not an arm's length transaction, between a parent and a subsidiary, then we ought to collect the royalty based on the market value.

Now, obviously, there is the opportunity when you have a parent dealing with a subsidiary to underprice the transaction and, therefore, not pay much royalty. And we are in the process of trying to get that or keep that matter under control.

Mr. Bettenberg may need to expand on what I have said.

Mr. **Yates**. I am told that the posted price in California is established by the pipeline.

Secretary **Hodel**. We are talking about natural gas in this case?

Mr. **Yates**. No. We are talking about crude oil. Posted price is by pipeline. The pipelines claim to be common carrier pipelines and yet they will take for transmission only the oil from companies that they choose to take it from.

They avoid the designation as private carriers. So they have a pretty good control over that system. This is what the lawyer sent to me. It says West Coast crude—this is a question of windfall profits taxes, too.

Let me be specific. "The underpricing of West Coast crude oil has been a problem for at least several decades." This letter is from the law firm of Lobel, Novins, Lamont and Flug, in Washington. I guess they represent the State of California for certain purposes.

[The information follows:]

LAW OFFICES OF
LOBEL, NOVINS, LAMONT & FLUG
SUITE 770
1275 K STREET, N.W.
WASHINGTON, D.C. 20005

(202) 371-6626
TELECOPIER (202) 371-6643

September 24, 1986

MEMORANDUM

West Coast Crude Prices and Windfall Profit Taxes

The underpricing of West Coast crude oil has been a problem for at least several decades. It has probably cost the state and federal governments hundreds of millions in lost royalty payments. But after passage of the Windfall Profits Tax and the increase in Alaskan ANS production, the problem took on a new dimension. The lost revenue between 1980 and 1985 is probably in the billions.

In simple terms it appears that the major West Coast oil companies assigned prices to their crude oils that were for below real market values. The evidence for this is extensive. West Coast crude prices have been much lower than the prices of comparable crude elsewhere in the country. On the other hand the prices of the refined products made from the West Coast Crudes have been quite comparable with prices elsewhere. There is no market-based explanation for this disparity between crude prices and refined product values.

To answer the obvious question why anyone would fix prices low, it is important to understand that the low crude prices were used by the major companies for only two purposes: buying crude from other people and calculating taxes and royalties. Other firms who purchased crudes were compelled to pay premiums or bonuses over the posted prices. (Hence considerable competitive damage was done to the independent refiners in California during this period.) However, taxes also provide a large part of the explanation.

Congress enacted the Windfall Profits Tax in 1981. On the margin where it really matters, it put a walloping 70 percent tax on revenues from crude production. This meant that for large companies a dollar earned in crude production was worth a lot less than a dollar earned elsewhere in the company. If the refining division could contrive to pay the crude producing division just a few cents less per barrel the results were spectacular. The General Accounting Office estimated that in 1984 a change of one cent per barrel would change the tax liability of the Alaskan North Slope producers $2.8 million a year. If all West Coast crudes -- Californian and Alaskan-- were underpriced for five years by four to six dollars a barrel, the cost to the federal government would be in the billions. Likewise, Alaska would have lost billions in severance taxes.

The next obvious question is how? In large part the ability to keep prices low is a matter of keeping the market closed to outsiders who would bid prices up to competitive levels. In part this ability is based on the fact that the major oil companies controlled virtually the entire California pipeline system. Moreover they operate their pipelines wholly as private carriers. This means that they can compel the sale of oil at the wellhead as a condition of shipment. Obviously this means not only substantial control over the prices but also the ability to exclude other purchasers. The matter is somewhat easier for the ANS producers. There are only three important producers, all with a common interest in avoiding both the WPT and state taxes, and with a single pipeline facility. They have consistently refused to enter into arms-length sales.

The WPT also explains another aspect of the West Coast crude price problem. The question is whether the "surplus" created by the ANS crude is not the explanation for low California prices. It costs around four dollars to ship a barrel of ANS crude past the California ports to the Gulf of Mexico. And surely the West coast price should have been, as Arco has claimed, the net-back from the Gulf minus the four dollars transportation.

There are a lot of things wrong with this argument. The most important is that the cost of shipping ANS crude past California net of taxes was not four dollars. It was more like fifty cents. The reason is the transportation charges for the ANS reduced the net-back value at the wellhead which, in turn, reduced the Windfall Profits Tax, and the state severance tax. In short, the prime market for ANS crude was not the West Coast but the Gulf. Thee was no "surplus" on the West Coast which could explain the underpricing.

Sincerely,

Henry Banta

Henry Banta

Mr. **Yates**. "The underpricing of West Coast crude oil has been a problem for at least several decades. It has probably cost the state and federal governments hundreds of millions in lost royalty payments. But after passage of the Windfall Profits Tax and the increase in Alaskan ANS production, the problem took on a new dimension. The lost revenue between 1980 and 1985 is probably in the billions."

"In simple terms it appears that major West Coast oil companies assigned prices to the crude oils that were far below real market values. The evidence for this is extensive."

"West Coast crude prices have been much lower than the prices of comparable crude elsewhere in the country. On the other hand the prices of the refined products made from the West Coast Crudes have been quite comparable with prices elsewhere."

Mr. **Regula**. Will the Chairman yield?

Mr. **Yates**. Surely.

Mr. **Regula**. Do I understand you correctly that the underpricing is because, in effect, it is the left hand telling the right hand and they are not selling it on the open market?

Mr. **Yates**. That is correct.

Mr. **Regula**. So they can assign——

Mr. **Yates**. They can post a price that is lower, that is right.

Secretary **Hodel**. Mr. Chairman, you are, in reading that letter, pleading the case of a lawyer who is attempting to make that case. I can assure you that if there is a basis for doing it, we would like to make a case, too. But I think he may well not mention in that letter that one of the restraints on the sale of oil along the West Coast has been the inability to place additional refineries there for all kinds of reasons. This puts the supplier of oil to that part of the United States in a disadvantageous selling position, because the surplus either has to pass through a pipeline, which has a limited capability—and I don't know what its current situation is—or across the isthmus in order to get to refineries in the Gulf Coast or other Caribbean areas.

Mr. **Yates**. I don't know whether this is true or not. If I am pleading his case, I leave that for the record and for you to decide whether it is prejudicial in any respect. I don't think it is. I think it states a situation, and if you think the situation does not deserve your inquiry and your action, that is up to you.

But I think——

Secretary **Hodel**. I am sure that we will and I am sure the IRS has or will.

PROBLEMS WITH INDEPENDENT REFINERIES

Mr. **Yates**. I will tell you the lawyer also told me independent refineries are going broke in California because they can't get the oil. It isn't a question of building additional refineries. There are independent refineries that are going broke.

Secretary **Hodel**. I find that incredible in the sense of not being believable.

Mr. **Regula**. Mr. Secretary, a question. In fact, do the companies sell to themselves?

In other words, do they have a production company which will, in turn, sell the crude that is produced from that production company to another corporate entity but part of the same family, and if so, how do they establish a fair market price for purposes of paying royalties since the royalty is based on what should be the fair market price in terms of what is paid to the Government?

Secretary HODEL. May I ask Mr. Bettenberg to give you an answer on that?

Mr. BETTENBERG. In fact, that happens all the time. Our rules are basically set up on the basis that when a company does not sell oil or gas at arm's length, we don't believe their pricing structure. We have a long history of knowing, through audit, that individual companies will move their profit to whatever is most advantageous.

Mr. YATES. Would you yield on that for one question?

Do you, where you find this condition to exist, go back and collect on back audits of the money that they should have paid you?

Mr. BETTENBERG. That is one of the major findings in the $320 million we have collected.

FAIR MARKET VALUE

Mr. REGULA. How do you determine the fair market value?

Mr. BETTENBERG. We use a variety of techniques. Let me give you one specific example that we are pursuing right now through the courts and through the penalties, procedures and so forth. That has to do with Marathon Oil, which produces natural gas in the Kenai field in Alaska, sends a substantial portion of that natural gas to their own liquification plant, puts it into their own tanker and sells it in Tokyo harbor to the Japanese.

The company was paying something around a dollar—paying royalties on the basis of something around a $1.80 per thousand cubic feet. We thought that was a low figure for what they were doing.

So what we did was what we call the net back audit in their case. We took the price of the natural gas sold as a liquid in Japan and then backed out all of their costs and, based on that, concluded that the price for valuation ought to be in the $3 range.

We are in court on that particular case and in that particular case, the company refused to pay up on our demand order, so we assessed civil penalties and before they stopped that in court with a settlement agreement, that penalty had risen to $20-some million dollars, a little over $20 million. That has been sustained by an administrative law judge through the appeals procedure and is currently before the Interior Board of Land Appeals.

The basic valuation case is in court in Alaska. We have a variety of other standards based on what other companies are getting for like quality crude in the field, for instance, for an area.

We applied those in one case that we ended up with an out-of-court settlement for $45 million, in fact; roughly $45 million. Of that, $320 million, roughly $45 million is one single case.

Mr. YATES. Is that the Marathon case?

Mr. BETTENBERG. No. That is a Union case. We don't have a settlement in Marathon's case yet. We have a variety of techniques like that to assess value and that is one of the major things that we find.

Mr. YATES. In your testimony before us, I don't understand your reply now. In your testimony before us in your fiscal year 1987 hearing on page 801, you say this in response to a question. Mr. Moyers was here at that time.

Mr. Moyers: "Of the $280 million in audit collections, about $30 million of that is for late charges and liquidated damages, so that, coupled with these figures, about $32 million."

Mr. Yates: "How much of that was collected? That is assessment, isn't that, or is that collection?"

Mr. Moyers: "That is collection."

Mr. Yates: "Out of how much? Let my try to get it straight. How much was assessed?"

Mr. Moyers: "Thirty-two million dollars. We have collected all of it that we have assessed."

Mr. Yates: "You have collected all that you have assessed."

Mr. Moyers: "For the penalties for the late payments."

Mr. Yates: "How about the other penalties?"

Mr. Bettenberg: "In addition to that, the Act provides for civil penalties, and we have one large amount that is pending before the Interior Board of Land Appeals. That was something in the range, as I recall, of about $20 million. That was with Marathon Oil for what we thought was egregious infractions, and they are in the process of paying."

"We have been working this past winter on development of what we call a comprehensive enforcement strategy. That includes using civil penalties on a more regular basis."

You used an audit system in which you price the distillates and went back to the crude that way, did you not, to find out the price of crude? Isn't that what you said?

Mr. BETTENBERG. In that particular case it was natural gas.

Mr. YATES. Okay. But do you frown on that system? The State of California, for example, in a draft of a letter to me says, "our effort has been frustrated by the failure of the Department to adopt reasonable procedures and guidelines . . . the Department consistently refuses to permit the use of the industry's own appraisal techniques to determine the amount of undervaluation."

[The information follows:]

KENNETH CORY
Controller of the State of California
SACRAMENTO, CALIFORNIA 95805

September 24, 1986

Honorable Sidney R. Yates
Chairman
Subcommittee on Interior
Committee on Appropriations
U.S. House of Representatives
Washington, D.C. 20515

Dear Mr. Chairman:

I understand that your Subcommittee will hold hearings this week to receive testimony from Interior Department representatives on problems in the audit and collection of mineral royalties from Federal leases.

Committee staff report that these hearings relate to the ongoing Conference between the Houses on current appropriations bills. Apparently, the issues still in conference include proposals to alter somewhat the share of royalties allocated to the public land States, and to consider reports that the Department's accounting and enforcement efforts have left uncollected substantial sums owing the United States and the States. However, we are informed, no witnesses other than representatives of the Department of the Interior or the Committee's own staff are scheduled to be heard.

The importance of these issues to the States involved, including my State of California, lead me to urge strongly that a more extended consideration of these problems is justified, allowing the States full opportunity to express their views. While I understand that an informal Committee of the State auditors concerned, including those on my staff, are preparing hasty comment on the issues involved, these can only raise questions, not propose solutions. As you know, under the Federal Oil and Gas Royalty Management Act of 1982 (96 Stat. 2447), enacted after extensive hearings Interior was authorized to allow interested States the opportunity to participate directly in the audit and collection of the royalties in which they share.

Since these royalties, dedicated in California to general education purposes, constitute a far more important budgetary item to the States than the Federal Government, virtually all of the States with Federal oil production have sought such participation. Our efforts, which have aided in the collection of substantial amounts of lease royalties, have at the same time required substantial time, effort and expense to train the audit staff involved and to organize the audit and collection effort. And, while a portion of the expense involved has been provided by the Federal Government, more than half has been at the expense of the State itself.

However, much of our effort has been frustrated by the failure of the Department to adopt reasonable procedures and quidelines for the valuation of the minerals produced on Federal leases. This is particularly critical to the production of oil and gas in California. There, despite clear and convincing evidence that Federal royalty oil is being sold and accounted for at prices which are substantially under its true market value, the Department consistently refuses to permit the use of the industry's own appraisal techniques to determine the amount of undervaluation. For example, such an analysis of several of the principal fields in California indicates that over $22 million should be collected from this source for onshore production for just two years -- 1981-1983. Parenthetically, the California offshore production, in which the State does not share, has, we believe, also been undervalued, and the total considerably exceeds the onshore deficiencies.

Also, delays incident to the Department's unwieldy accounting procedures have significantly added to the costs of collection, both to the States and the Department, particularly in relation to the interest required to be paid the States for any departmental failure to disburse the State share promptly. Thus, the 1983 statute was intended to insure that money due be promptly collected, and made available without delay to the States and to the Treasury. As a part of this, interest was to be paid on shares withheld from the States for more than a month after the month of collection, not as added compensation, but as a spur to rapid disbursement.

Even with a tortured construction of the statute that such interest does not begin to run until after the Department has received funds and successfully sorted out their complex accounting to trace the source and purpose of the receipt, a process usually covering several months, the interest charges have mounted. This cost, however, is not due to the States involved, but quite simply to the failure of the Department to install accounting methods which fully and promptly account for cash receipts, and which fully and promptly penalize payors for careless or willful failure to pay or report on time.

This, we note, is not due to lack of statutory authority. Ample provision is made for penalties for any unwarranted delays in payment or accounting by the lessees. Yet, in the four years since the statute has been enacted, there has yet to be any serious invocation of the penalty process.

Many of the matters discussed here are encompassed in the draft regulations which the Secretary has transmitted to his Royalty Management Advisory Committee (RMAC) for review and revision. As originally established, the RMAC was to be composed of a balanced group of individuals from industry, the States, the Tribes and the public. The Secretary originally mandated that any recommendation from the RMAC be made only on a vote of two-thirds of the entire membership to assure that their recommendations truly reflected a consensus.

In the course of its proceedings, the industry proposals made for regulations governing oil and gas valuation have been unable to achieve the necessary two-thirds majority. Now, I understand, the Secretary may be considering a change in the ground rules to permit approval on a vote of two-thirds of the members present. Since all of the States and Tribes concerned are subject to budgetary constraints and thus are unable to assure that their members are present at each RMAC meeting, and since virtually all of the "public" members of the RMAC are affiliated with the industry, such a change in voting rules will make it likely that any recommendations made will not reflect any true consensus. In short, I am particularly concerned that the rules change would allow the RMAC domination by industry interests to deceive Congress and the public into a belief that the RMAC recommendations represent a public interest consensus, and that the recommendations warrant adoption by the Secretary.

As this letter indicates, there are deep and abiding problems in the administration of royalty collection and accounting by the Department of the Interior. These problems justify full and fair inquiry by all the Committees concerned. At the very least, those States having direct concern with the problem should have an opportunity to prepare and present material relevant to these issues.

Sincerely,

Kenneth Cory

Kenneth Cory

Mr. **Bettenberg**. I would have to review what they are talking about in that particular case.

Mr. **Yates**. I suggest you call Mr. Kenneth Corey who is the Controller of the State of California who has given us that information. Now, let me go back to the State of California and the hundreds of millions of dollars that he says are not being collected because of underpricing.

"The evidence for this is extensive. West Coast crudes have been much lower than the prices of comparable crude elsewhere in the country. On the other hand the prices of the refined products made from the West Coast Crudes have been quite comparable with prices elsewhere."

"There is no market-based explanation for this disparity between crude prices and refined product values. To answer the obvious question why anyone would fix prices low, it is important to understand that the low crude prices were used by the major companies for only two purposes: buying crude from other people and calculating taxes and royalties." Obviously if the price of crude is lower, the amount of royalties they pay out is lower. The amount—they escape taxation, windfall profit taxes, for example.

"(Hence considerable competitive damage was done to the independent refiners in California during this period.) However, taxes also provided a large part of the explanation."

"Congress enacted the Windfall Profits Tax in 1981. On the margin where it really matters, it put a walloping 70 percent tax on revenues from crude production. This meant that for large companies a dollar earned in crude production was worth a lot less than a dollar earned elsewhere in the company."

"If the refining division could contrive to pay the crude producing division just a few cents less per barrel the results were spectacular. The General Accounting Office estimated that in 1984 a change of one cent per barrel would change the tax liability of the Alaskan North Slope producers $2.8 million a year." One cent a barrel.

"If all the West crudes—California and Alaska—were underpriced for five years by four to six dollars a barrel, the cost to the federal government would be in the billions. Likewise, Alaska would have lost billions in severance taxes."

Secretary **Hodel**. They get 90 percent.

Mr. **Yates**. Right. "The next obvious question is how? In large part the ability to keep prices low is a matter of keeping the market closed to outsiders who would bid prices up to competitive levels."

"In part this ability is based on the fact that the major oil companies controlled virtually the entire California pipeline system. Moreover they operate their pipelines wholly as private carriers."

"This means they can compel the sale of oil at the wellhead as a condition of shipment. Obviously this means not only substantial control over the prices but also the ability to exclude other producers."

"The matter is somewhat easier for the ANS producers. There are only three important producers, all with a common interest in avoiding both the WPT and state taxes, and with a single pipeline facility. They have consistently refused to enter into arm-length sales."

Now, he talks about private carriers controlling it. He also informs me that you can break this if you want to.

RESPONSIBILITY OF SECRETARY REGARDING PIPELINES

Secretary **Hodel**. I can't comment then, Mr. Chairman. That is a major anti-trust price fixing accusation there that is really beyond our purview. Mr. Bettenberg has described in some detail how we try to get at our responsibility.

Mr. **Yates**. Strike that then.

Secretary **Hodel**. But if there is merit to that case, then he ought to be writing and may well have written the Justice Department Anti-Trust Division and presumably they will pursue it——

Mr. **Yates**. If there is merit in this case, shouldn't you be writing the Justice Department, too.

Secretary **Hodel**. If there is some evidence we think justifies it, we will, but this is clear opinion and he says if, if, if, and then he reaches these conclusions.

Mr. **Yates**. Then I take it what you are saying is that as far as you know there is no underpricing in California?

Secretary **Hodel**. That is not what I am saying, Mr. Chairman. What I am trying to say is that you are not reading from a letter from what could be viewed as the most reliable source.

Mr. **Yates**. You said that. I said that.

Secretary **Hodel**. I agree. Then you are asking me what I should do based on that source and I am suggesting——

Mr. **Yates**. I was leading up to something.

Secretary **Hodel**. Okay.

Mr. **Yates**. He contends that the pipeline companies claim to be common pipelines. He also has told me that the pipelines cross Federal lands, some of them. There is a statute that says if pipelines cross Federal lands they have to be common carriers.

Were you aware of that?

Secretary **Hodel**. I am not aware of that, no.

Mr. **Yates**. You want me to read it to you?

It is 30 U.S.C., Section 185, Subsection (r)(5). It says, "[W]henever the Secretary has reason to believe that any owner or operator subject to this section is not operating any oil or gas pipeline in complete accord with its obligations as a common carrier hereunder, he may request the Attorney General to prosecute an appropriate proceeding before the Secretary of Energy, or Federal Energy Regulatory Commission, or any appropriate State agency or the United States district court for the district in which the pipeline or any part thereof is located, to enforce such obligation or to impose any penalty provided therefor, or the Secretary may, by proceeding as provided in this section, suspend or terminate the said grant of right-of-way for noncompliance with the provisions of this section."

That is the law. The reason I cite that is to call it to your attention. If that is happening, you ought to be in on it. I don't know if it is happening.

Secretary **Hodel**. I appreciate what you are saying. I will go back and follow up on it for the obvious reasons. We do attempt to pursue the valuation question and are concerned.

Mr. **Yates**. I agree with you he has an axe to grind in his lawsuit. You have an axe to grind on behalf of the taxpayers, on behalf of the States, on behalf of the Indian tribes in California at least and possibly in other States.

I don't know where underpricing may occur if there is underpricing. I don't know whether there is.

Secretary **Hodel**. We have asserted that there is, and in those cases where we think we have a case we have attempted to remedy it through our collection procedures and we will continue to do that wherever we think we have a case to do that, Mr. Chairman.

Mr. **Yates**. You and Mr. Bettenberg have cited that case; is that right?

Secretary **Hodel**. And there are others.

Mr. **Yates**. There are others. Would you tell us what the others are then where you are proceeding?

Secretary **Hodel**. Perhaps I am mistaken if we don't have other cases.

Mr. **Bettenberg**. We have lots of other cases. That is what the $320 million is all about. It represents hundreds and hundreds of cases.

Mr. **Yates**. Okay.

SUN OIL CASE

Mr. **Bettenberg**. We are in court right now with I believe it is seven companies over something called the "take-or-pay" issue. You referred a little earlier to a letter that involved Sun Oil from Oklahoma. That is entirely accurate.

Sun has not provided us the records in that case. It is what we call a take-or-pay case. I need to back up and give you some background on it. A lot of gas contracts are written in such a way that if the company buying the gas, which is often a pipeline company, doesn't take the gas that they have contracted for on some sort of even rate, roughly even rate, but instead stops accepting the gas, that there is a paper settlement. We have taken the position that that settlement amount is wrapped into the value of the gas provided and/or to be provided and that royalty is due on it.

To the best of my knowledge, every gas company disagrees with that position and they take the position that since they don't owe royalty on this amount, then FOGRMA and the requirement for records also does not apply.

Now, we are in court in the western district of Louisiana and the eastern district of Louisiana with a whole series of companies trying to win the argument that, in fact, they owe royalties. If they owe royalties, then they owe us the records.

If they don't owe us the royalties, then they don't owe us the records I would presume. The court will decide that as well, but that is another example of a case where we are, in fact, in court pursuing those things.

We have done all of that within the last nine or ten months.

Mr. YATES. Now, how does it happen that you are in court? Were they the result of Inspector General audits?

Mr. BETTENBERG. No. I take it back. Probably some of them were Inspector General audits and some of them were our audits, I would assume. And some of them were initially Inspector General audits that we ended up subsequently taking over.

In these particular cases, I signed the determination order and had it counter-signed by the Assistant Secretary so that we would move immediately to court because we knew the case would go to court eventually and we needed a decision.

Mr. YATES. Now, take-or-pay, all right.

That is what you said about take-or-pay and Sun. You said MMS stated there are several significant take-or-pay cases and you are not inclined to pursue additional cases. The State/Tribal Royalty Audit Committee says that they think this is unacceptable.

There are several avenues available to the MMS to force compliance with their rules and regulations, including the imposition of civil and criminal penalties provided by Section 109 and Section 110 of FOGRMA.

That is what the State says. Now, you indicated you had recovered $320 million. Okay. I will accept that as being an achievement.

Is that the sum total of recoveries over the last five, six, seven, eight, nine, ten years?

Mr. BETTENBERG. It is the sum total since I think about the end of 1981, which is essentially when our current audit program was being created. The amount is accelerating.

This past year it is, as I recall, to date, it is something like $110 million.

PENDING LOOKBACK AUDITS

Mr. YATES. How many lookback audits do you have pending?

Mr. BETTENBERG. To the best of my recollection, the Inspector General has provided us with the last of their lookback audits this year. Some of those have issues still to be——

Mr. YATES. Say that again.

Mr. BETTENBERG. The Inspector General has provided us with the last of their lookback audits.

Mr. YATES. They say their lookback audits terminated in 1983. That is what they told us.

Mr. BETTENBERG. Mr. Chairman, I believe what they were telling you was that probably their last contract for lookback audit was let in 1983. They do these by contract and the results come in some time later. My recollection is the last of these have come in this year.

Mr. YATES. Well, then what you are saying is that the Inspector General audits which were paid for prior to 1983 are now starting to come in. Because the Inspector General is telling us he does not have any money to do it.

Mr. BETTENBERG. I think probably the last of them are coming in at this point. I don't recall exactly how many they were doing——

Mr. YATES. That is three years prior to 1983.

Secretary HODEL. May I interject?

I probably should not, but I think there is a misunderstanding developing here because of the term lookback.

Mr. Bettenberg was answering specifically the lookback portion of your question, but all audits are lookback and not all audits are conducted by the Inspector General. Of the Inspector General audits, as of March 31, some $47 million have been collected.

That means a lot of the other money had been collected because of audits conducted by the MMS staff and those continue, I believe; is that correct?

Mr. **Bettenberg**. The figure that I have is $19 million collected. I take that back. That figure, the figure that the Secretary is quoting, could include late payment charges and miscellaneous things like that, possibly some refund denials I have categorized in somewhat different ways.

Mr. **Yates**. This is what the Inspector General says. "The lookback audits involving 34 of the top 50 royalty payors . . . focused primarily on the period from January 1, 1977, through August 31, 1981, when conversion from the RAS to the IOS began."

He says, the potential lookback underpayments that he identified is $132 million relative to the total royalty payments during the audit period. He has just gone through 1981 according to this. What has happened in the later years, though?

Secretary **Hodel**. Mr. Chairman, a piece of paper prepared for me by the Inspector General says as of March 31, 1986, the Office of the Inspector General reported royalty underpayments of $131.5 million or $132 million. That is March 31, 1986.

Mr. **Yates**. That isn't what he said here. He said he has identified it as being for the period January 1, 1977 through August 31, 1981. His letter—his other letter says that since 1983 they haven't had any money to pay outside contractors and he does his lookback audits through outside contractors in the main.

He hasn't been able to go beyond that period. That is why I am now asking how many lookback audits are going on.

Secretary **Hodel**. Mr. Chairman, when we came in, one of the things we set the Inspector General to do was to conduct these special audits as the Inspector General——

Mr. **Yates**. Right.

Secretary **Hodel** [continuing]. To find out what had happened in these major companies and that, I believe, is what we have had reported to us. He did that largely through contracts with outside accounting auditing firms.

At the same time, the Minerals Management Service was to begin a process of routinely auditing the accounts so that we did not fall in arrears. When we came in we felt there were years of non-audit that needed to be remedied and we tried to remedy that with what we called the lookback audit.

But we were supposed to put in place an auditing system by which MMS would pick up the ongoing auditing responsibility. Now, in both of those activities we find underpayments or alleged underpayments. Incidentally, in the Inspector General's payments here he says of that $132 million it was reduced by post-audit MMS determinations to $123 million.

There was just an agreement that some of it was too much, very much like an IRS process. $47 million was collected. $13 million is held pending legal issues. $45 million is open or unresolved. I have got this wrong. Let me——

Mr. **Bettenberg.** Forty-five million dollars is pending legal issues.

Secretary **Hodel.** Okay. I read the dashes wrong. They have collected $47 million, they have assessed $13 million, pending legal issues, $45 million, and open or unresolved is $16 million. So they come in different categories. Some of that money may be collected this year, some next year and it will add to this $320 million figure and at the same time adding to the $320 million will be continuing audits of the Marathon Oil type, the type you have drawn to our attention here today with the letter about the pipelines in California, all of which we have to continue doing and will do.

Mr. **Yates.** How many lookback audits are going on now?

Mr. **Bettenberg.** If we define lookback audits as the one——

Mr. **Yates.** The kinds that were conducted by the Inspector General.

Mr. **Bettenberg.** I think what I testified was: my recollection is that we received the last of those, which would indicate none.

Mr. **Yates.** None. Okay. So for all intents and purposes, then, you are satisfied with the royalties that you have been getting from the companies. You are assuming that the auditors that you have on board at the big oil companies who are working primarily on the major payors are able to detect any errors in payment by the oil company. There are no lookback audits. You assume that lookback audits will not collect any money.

Mr. **Regula.** Will the chairman yield? I think there are no lookback audits at the Inspector General but MMS is conducting ongoing audits.

TYPES OF AUDITS

Mr. **Yates.** What kind of a lookback audit has MMS conducted? I asked him for any lookback audits he was conducting of the kind that the Inspector General had been conducting.

Mr. **Regula.** I understand.

Mr. **Bettenberg.** MMS—I think we need to get over the word lookback. We have auditing. When we audit, we go back typically six years. That is what an audit is all about. I think perhaps you don't understand that.

Mr. **Yates.** How many such audits do you have where you are looking back six years?

Mr. **Bettenberg.** I think the typical audit goes back six years.

Mr. **Yates.** How many typical audits do you have?

Mr. **Bettenberg.** I don't think I have the figure here on how many audits we have actually completed.

Mr. **Yates.** I didn't ask how many you have completed. I know the Inspector General has completed some for the cycle between 1977 and 1981. Between 1981—that is what he says in his report.

Mr. **Regula.** Mr. Chairman, I am confused because by this annual report of 1986 he says as of December 31, 1985, audits of 34 of the top 50 royalty payers, and 10 gas processing plants disclosed, etcetera, etcetera. It sounds like he went up to December 31 of 1985 on his audits.

Mr. YATES. He quit. He ran out of money. He finished the audits he had for a period 1977 to 1981. He had conducted those audits by hiring outside accounting firms. He had no money after that time to hire outside contractors, and it isn't because we failed to give him money. We didn't know anything about it. We know a little bit more about it now, and I wish the Inspector General had come in and asked us for the money.

Secretary HODEL. Mr. Chairman, we would have resisted money for the Inspector General for the reason we believe the proper audit function needs to be carried on by the Minerals Management Service because it has an enforcement function. That audit function, in our view, is being carried on. If I may repeat that——

Mr. YATES. Sure you may.

Secretary HODEL. When we came in, there was catch-up auditing to do, and we called it lookback.

Mr. YATES. So what you are saying is you took care of whatever needed to be taken care of as a result of the transition, but since you made the transition in 1983, there is no need for anymore of this kind of auditing?

Secretary HODEL. Actually, Mr. Chairman, the simultaneous auditing by MMS should have begun picking up right while the "lookback audit" was being conducted by the Inspector General If I may put it this way, you ought never to have a need for a special audit process called a lookback. You ought to be on top of your auditing all along. That is what we are trying to achieve, and that is actually what this computer system is intended to do.

Mr. Chairman, we are auditing the major companies continuously. They are under constant audit.

Mr. REGULA. You are really saying whatever the Inspector General does is a remedial——

Secretary HODEL. It was intended to be remedial, right.

Mr. REGULA. But not a continuing program.

Secretary HODEL. We don't think the Inspector General ought to be in the line carrying on routine audits because if the Inspector General conducts routine audits, who inspects the Inspector General? We need to have him in a position to come in and audit periodically, as an Inspector General, whether MMS is doing its audits properly, but it is clearly an MMS management responsibility to audit.

In fact, we have serious debates internally, Mr. Chairman, as to whether or not the Inspector General or the MMS should do the lookback audits for that very reason. It would be very difficult for us now to ask the Inspector General to investigate whether he did the lookback audits correctly. Of course he did, in his view.

So the point is that was a remedial effort and the issue could well be—this I think is where you are headed in your questioning—is are we now doing the level of audit that is appropriate. We think that is a MMS function, and the question may well be is it at the appropriate level; are we auditing enough companies.

Mr. YATES. You know, Mr. Secretary, that argument just can't be validated. If your auditing procedures were so sound, why do you state in the justification for an additional 50 auditors that with this expenditure of money, for the extra 50 auditors, for $2.5 million you will be able to recover another $20 million? That, on the face of it, shows your auditing procedures are inadequate, doesn't it?

Secretary Hodel. No.

Mr. Yates. Why not? It shows that if you put more auditors on you are going to collect more money.

Secretary Hodel. Yes.

Mr. Yates. So therefore they are inadequate.

Secretary Hodel. Therefore——

Mr. Yates. Presently without the 50 auditors it is inadequate.

Secretary Hodel. Mr. Chairman, you said our procedures were inadequate. I would suggest our procedures are adequate. What I am saying to you is we need to put more resources in to carry out those procedures.

Mr. Yates. Why didn't you tell us that in our regular hearing, then? You are telling us now because we put money in for the 50 auditors. At the time you didn't say you needed any more.

Mr. Bettenberg. The record should show that suggestion came from me to your assistant and we provided the documents from which you did it.

Mr. Yates. After the hearings were over. I asked you the same question I ask you every year: Do you need any money for any more function? Every year you told me you didn't need more money. Isn't that correct?

Mr. Bettenberg. That is correct.

Mr. Yates. Now, inasmuch as you are engaged in so much auditing through the use of your regular auditors, how much time does MMS spend auditing—these are on the major companies—how much time do your auditors spend in auditing Indian leases, FERC orders, reconciliation of old contracts and refunds? Those are your functions too, are they not?

Mr. Bettenberg. Yes. I don't have a figure on refunds, although its' substantial. On Indians, our current figure is, as I recollect, something like about 28 or 29 percent of our audit time is on Indian matters. Reconciliations, I don't have a figure on that but most of that would be included within the Indian number because most of that that is going on at this point is Indian leases. I think we are to be wrapped up with those at the end of this year.

Mr. Yates. Can you provide us with information as to how much of your auditing staff goes for these serious functions, how many of your auditors are involved in the major leases, oil leases with the Federal Government, how many with Indian leases, how many of your auditors are busy with FERC orders, how many are busy with the reconciliation of old contracts, and how many are busy with refunds? Would you provide that for the record?

Mr. Bettenberg. Yes, we will provide that for the record.

[The information follows:]

Use of Audit Staff Resources

During the first 11 months of fiscal year 1986, the Minerals Management Service has utilized its audit staff resources approximately as follows:

	Staff years
Federal Lease Audits	23
Indian Lease Audits	30
FERC Order 93 Refund Reviews	6

	Staff years
RAS Reconciliations	15
Other Refund Reviews	12
Other Audit Activities	31
Total	117

ADDITIONAL AUDITORS

Mr. **Yates**. And also, if we propose to give you 50 more auditors, how are you going to use them?

Mr. **Bettenberg**. We will have additional residency auditors.

Mr. **Yates**. Where?

Mr. **Bettenberg**. I don't have that with me but I can provide that for the record. We will have auditors at our regional and subregional offices auditing other companies where we don't have residencies, and we will put a substantial amount of that into the state audit organization to whom we have delegated audit authority for onshore leases in those states.

[The information follows:]

Twenty-five (25 of the additional 50 auditors will augment existing residencies. Another ten (10) auditors will staff new residencies in Dallas and in Houston, Texas. The remaining fifteen (15) auditors will be used primarily on mobile audit teams working on specific projects as needed. The following chart displays the currently projected allocation of the 50 additional auditors provided by the Congress.

Number of auditors added

Audit location:	
Texas (current residencies)	13
Texas (new residencies)	10
Oklahoma	6
California	2
Ohio	2
Louisiana	2
Mobile audit teams	15
Total	50

Mr. **Yates**. You indicated in response to an earlier question that you had underpricing cases in court now, underpricing by oil companies.

Mr. **Bettenberg**. Yes, we have such cases.

Mr. **Yates**. How many such cases are you looking at?

Mr. **Bettenberg**. There are at least several that are underpricing per se.

Mr. **Yates**. Several? Two or three?

Mr. **Bettenberg**. I think probably two or three.

Mr. **Yates**. Where are those? Where is it alleged that the underpricing occurred, in what states?

Mr. **Bettenberg**. One of them is Alaska. We have been in court for some time in New Mexico involving the Jicarilla case. The take-or-pay case is probably not something we consider a pricing procedure per se.

Mr. **Yates**. Do you have any underpricing cases arising in California?

Mr. **Bettenberg**. We have definitely had them in terms of audit findings and collections. We have probably had them in terms of appeals to me and possibly before the Interior Board of Land Appeals.

Mr. YATES. Are these underpricing cases you are talking about?

Mr. BETTENBERG. I would anticipate it would be not only underpricing but other kinds of cases as well. We would give you an account of that.

Secretary HODEL. The larger category is underpayment and under that category of underpayment, we have underpricing——

Mr. YATES. This is true, but I am looking for the underpayments that result from underpricing.

Secretary HODEL. You are asking specifically about the underpricing kind of situation we described earlier.

Mr. YATES. Right. You would concede that is a valid area for search.

Secretary HODEL. Absolutely.

Mr. BETTENBERG. We can provide that information for the record.

Mr. REGULA. In your submission to the OMB, did you ask for more auditors than you were given?

Mr. BETTENBERG. We did not for this year.

Mr. REGULA. But you have in past years?

Mr. BETTENBERG. Excuse me, for this coming fiscal year. The reason was at the time we submitted the budget and at the time we held the hearing, I thought they were probably adequate. Later, I was going over some of the information on our audit collections; I concluded that we had a substantial shortfall in terms of capability to perform under the system that we use and so I sought additional resources to do that.

Mr. YATES. I noticed Mr. Moyers said in his testimony that we will have maybe 400 or 500 ongoing audits at any one time. Is that still reasonably correct?

Mr. BETTENBERG. Yes. That would be correct.

In responding to that question, I think one way of looking at it is that we have basically been in the business of auditing in a substantial way since late 1981. Perhaps I should even say later than that, because during the early period the auditors were often pulled off of audit work or were doing work that wasn't as productive as it might have been.

Out of the $320 million collected, I just did some rough numbers here, and it looks like probably something like $235 or $240 million of that has been by our auditors during this period of the last few years.

I would anticipate that we would have that large number of audits ongoing at any one time and many of them might involve many leases.

I saw one figure in just recently that of the 4600 Indian leases, it looks like we have looked at in the last four or five years some 1200 of those. Of course, within those we concentrate on those where we have the best shot at collecting money.

We have, I think, a very bright audit staff.

Mr. REGULA. I know the Inspector General in his report says, even though corrective actions have not always been timely, we believe that the department has made significant progress and "is committed to the full implementation of an effective royalty management system." So he is saying there have been deficiencies but you are working at it.

Mr. Chairman, whenever we have a little time, I would just like for the record to get the procedure involved in the leasing process.

Mr. YATES. I just want to finish up with the list.

AUDITORS OF INDIAN LEASES

Mr. Bettenberg, refresh my memory; how many of your auditors are devoted to Indian leases?

Mr. BETTENBERG. The latest estimate I have seen is 28 or 29 percent.

Mr. YATES. The figure of 28 you used when I asked you that same question in the hearings this year when you said—"[W]hat I am saying is that we do have, in fact, a large team of auditors who are working on Indian leases, both Tribal and allotted."

Mr. Yates: "How many do you have?

Mr. Bettenberg: "We have 20-some who are dedicated exclusively to Indian matters right now, 28."

Then you said 28. Then there is a committee note in the hearings. The agency had subsequently corrected the number of auditors from 28 to eight.

Mr. BETTENBERG. If I could recorrect that, Mr. Chairman.

Mr. YATES. You are entitled, I guess, to two recorrections.

Mr. BETTENBERG. We didn't make the first correction, in fact. I looked back into that and the document that we provided to the department took the words "20-some" and crossed out the zero and the word "some" and wrote eight above it, and that apparently got transcribed—

Mr. YATES. What should the correct figure be?

Mr. BETTENBERG. At that time for what we were specifically addressing on that question, I said 28. I am advised by my audit staff they think about 28 or 29 percent of our total audit resources this year will be used on various kinds of Indian audit work and that is of 128. So probably the number is something more like 40 staff years.

It is important to understand that an individual auditor might be working at a company such as Exxon and one day be auditing an OCS lease, on another day be auditing a Federal onshore lease and on a different day be auditing an Indian lease. So we are probably better off talking in terms of percentage of resources than number of individual auditors.

MMS CAPABILITY

Mr. YATES. Then we go back to the hearings of 1986 starting on page 49 of part 8.

Mr. Murtha, that follows my questioning and I am asking you, Mr. Murtha was asking you about the Washington Post report about the government losing millions of dollars as a result of MMS's inability to handle the job.

Mr. Bettenberg: "I think there is no question the Government was losing millions of dollars back then. It is still losing some money."

"We are pretty sure we probably don't have every single lease in our file right now, and every interest holder in our file."

Mr. Yates: "You mean you don't know who they are?"

Mr. Bettenberg: "We don't know every single one of them."

Mr. Yates: "Why do you not? Doesn't BLM have it?"

Mr. Bettenberg: "Probably the government some place has a record. We have something like 50 people that are working on the project right now just cleaning up lease data files. The first step was to get them all in the system . . ."

Then Mr. Murtha asked the question: "Well, your auditors, then, are paying for themselves, your 90 auditors?"

Mr. BETTENBERG. The 90 auditors at that time two years ago.

Mr. Murtha: "All right. You need more auditors then? That is

Mr. MURTHA. "All right. You need more auditors then? That is the question. Can you use more auditors in order to expedite or get this thing concluded?"

Mr. Bettenberg: "At this point, I think we are in good shape on our auditors. Where we are less than good shape, but where we are working is on the financial systems that will minimize the amount of work auditors have to do and will focus auditor's time.

Mr. Murtha: "You are talking about the computer system . . .?"

Mr. Bettenberg: "That's correct."

PAYMENT TO INDIAN TRIBES

All right. Let's go back to another question. That is a question of payment to the Indian tribes. You don't pay on time, do you?

Mr. BETTENBERG. Generally, yes. We do pay on time.

Mr. YATES. Oh? It is not what the Indian tribes say, is it? You don't pay your allottees on time, do you?

Mr. BETTENBERG. Generally, yes. But I can give you instances, certainly, where we haven't.

Mr. YATES. Again I hear from a law firm. Apparently this is the law firm of Nordhaus, Haltom, Taylor and Taradash, which wrote to me out of the blue. They are in Albuquerque, New Mexico. *Shii Shi Keyah Association* v. *Hodel.*

They are saying you can't handle the job you have as far as the Indians are concerned, and so the language they use, and I will let you answer as soon as we are through reading this—this letter may go into the record—"[t]he Department of the Interior quite simply now seeks congressional approval and the official sanctioning of Congress for their incredible incompetence. The needless suffering of tribes and individual Indian allottees due to the late payment of their oil and gas royalties makes this latest maneuver of the Department of the Interior to attempt to sneak through legislation, which will eviscerate the main purpose of FOGRMA, a particularly obscene gesture. In light of the trust responsibility which the Department of the Interior, above all others, is enjoined with performing, this attempt to go behind the backs of the tribes and Indian allottees is absolutely outrageous.

"On behalf of all Indian allottees and tribes who have struggled to get the Secretary of the Interior into the 20th century and into compliance with the Federal Oil and Gas Royalty Management Act of 1982, I strongly encourage you to categorically reject any attempt to amend the Act."

[The letter follows:]

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September 11, 1986

Honorable Sydney R. Yates
Chairman, Subcommittee on the
Department of the Interior and
Related Agencies of the Committee
on Appropriations
Room 2234
Rayburn House Office Building
Washington, DC 20515

Attn: Jocelyn Hunn

Re: Federal Oil and Gas Royalty Management Act of 1982/Shii Shi Keyah Association v. Hodel

Dear Congressman Yates:

Enclosed herein you will find the Department of the Interior's proposed amendment to FOGRMA and the Federal District Court's ruling in our case mentioned in the Interior's "justification" for their recently introduced attempt to eviscerate FOGRMA. The relevant documents are: The motion and briefs filed on the question of timeliness of payment under Section 104(b) of the Act. This is the section that the Department of the Interior now wants to gut. Your particular attention is drawn to our reply brief which contains quotes from numerous senators and congressmen that took the floor during the debate over FOGRMA. Also, you should particularly note the attached affidavit to our reply brief of Mr. George Hill, a senior partner of Arthur Andersen & Co. Mr. Hill's affidavit shows, contrary to the self-serving assertions made by the Department of the Interior personnel, that compliance with the law as it now stands is technically and realistically possible.

The Department of the Interior quite simply now seeks congressional approval and the official sanctioning of Congress for their incredible incompetence. The needless suffering of tribes and individual Indian allottees due to the late payment of their oil and gas royalties makes this latest maneuver of the Department of the Interior to attempt to sneak through legislation, which will eviscerate the main purpose of FOGRMA, a particularly obscene gesture. In light of the trust responsibility which the Department of the Interior, above all others, is enjoined with performing, this attempt to go behind the backs of tribes and Indian allottees is absolutely outrageous. On behalf of all Indian allottees and tribes who have struggled to get the Secretary of the Interior into the 20th century and into compliance with the Federal Oil and Gas Royalty Management Act of 1982, I strongly encourage you to categorically reject any attempt to amend the Act. Our particular concern is that the Department of the Interior may seek to attach this amendment as a rider to some other unrelated piece of legislation and thereby "sneak" it through Congress. Please help us to ensure that this does not occur.

Of course, if I can provide you with additional information, I will be delighted to do so upon request.

Respectfully yours,

NORDHAUS, HALTOM, TAYLOR & TARADASH

Alan R. Taradash

ART:df
Enc.

INDIAN ROYALTY DISBURSEMENTS

Sec.___ . (a) Section 104(b) of the Federal Oil and Gas Royalty Management Act of 1982, 30 U.S.C. 1714, is amended by striking out the words "the appropriate Indian account" and inserting in lieu thereof the words "aggregate Treasury accounts maintained for Indian allottee and tribal revenues".

(b) Section 111(d) of the Federal Oil and Gas Royalty Management Act of 1982, 30 U.S.C. 1721(d), is amended by redesignating the present subsection (d) as paragraph (1) and adding a new paragraph (2) as follows:

> "(2) The Secretary shall pay interest on all royalty funds identified as Indian funds and deposited to an aggregate Indian allottee or tribal revenues account but not disbursed to, or made available for disbursement to, a tribe or an individual allottee, on or before the last business day of the month following the month in which the Secretary received such funds at the rate applicable under section 6621 of the Internal Revenue Code of 1954, from the required disbursement date until the date of actual disbursement to, or availability for disbursement to, a tribe or an individual allottee. This paragraph shall apply to funds received after March 31, 1987."

EXPLANATION OF INDIAN ROYALTY DISBURSEMENTS

Subsection(a) amends the wording of section 104(b) of the Federal Oil and Gas Royalty Management Act of 1982 ("FOGRMA") to clarify the original Congressional intent. The amendment reflects existing law. Under longstanding lease provisions as well as applicable regulations, royalty payments and reports are due at the end of the month following the month of production. As a practical consequence, the bulk of payments and reports are received in the last 2 working days of the month. Under these circumstances, it is not possible to process royalty receipts and accompanying lease production and sales reports to disburse royalty funds to individual allottees or tribes by the end of the same month. In many (if not most) cases, that would require disbursement of funds to individual allottees on the same day the Interior Department receives the funds. The Congress rejects the interpretation given to the existing section 104(b) language by the United States District Court for the District of New Mexico in its Memorandum Opinion and Order of March 24, 1986, in Shii Shi Keyah Association v. Hodel, No. 84-1622 M Civil. The present 30 C.F.R. 219.103 is a valid interpretation of the current statutory provision.

Subsection(b) adds a new provision to FOGRMA section 111(d) to set a firm deadline by which the Secretary must disburse royalty funds. However, it takes into account certain circumstances in which funds are sometimes held in BIA - managed accounts and not immediately released. In the case of tribal funds, tribal governments request BIA's Albuquerque Investments and Accounting Office, through their local agency office, to transfer funds from the aggregate tribal revenues account to the particular tribe's account in a commercial bank. Approval of this transfer is contingent on the Tribe having an approved operating budget on file with BIA. Twice each month, MMS mails a copy of the lease-specific Indian Financial Distribution Report (IFDR) to each tribal office. This report serves as notification to the tribe that funds are available for transfer. The tribe may wish to leave the funds in the aggregate account for any of several reasons. Hence, the Department's responsibility under paragraph 111(d)(2) is complete when the funds are available for distribution to the tribe. Likewise, there are situations where royalty funds are not automatically disbursed to an individual Indian allottee mineral owner, e.g., the individual is a minor or not competent to manage his or her own affairs or the lands in question are in probate. In such situations, the Department's responsibility is complete when the funds are deposited to the Individual Indian Money Accounts managed by BIA as trustee.

BIA's development of data processing systems to handle allottee disbursements, together with the implementation of the Minerals Management Service's (MMS) accounting system on upgraded computer hardware, should enable the Department to meet the prescribed deadline in most instances. The MMS and BIA systems, however, are not yet fully installed. The added paragraph 111(d)(2) therefore will apply to funds received after March 31, 1987.

FLOW OF INDIAN REVENUES

Month	Day	Activity
January	1 - 31	Oil and gas is produced and sold.
February	1 - 28	Pumper collects run tickets (oil) and meter charts (gas); mails to producer or purchaser's accounting center. Accountants calculate volumes sold and obtain sales price, allocate revenues to royalty and interest owners through payables and receivables, compile, prepare and submit MMS 2014's by the end of the month.
March	1	MMS deposits previous day's receipts in Treasury suspense account (daily). MMS calls BIA to advise of deposits to aggregate tribal and allottee investment accounts (daily). BIA invests deposits to aggregate tribal and allottee accounts (daily). MMS begins data entry and processing of reports submitted in February.
	15	MMS accounting system generates reports allocating revenues to leases, begins second accounting run for lines which were not reported out because of errors, etc.
	17	BIA receives MMS report, begins allocating lease revenues to allottees through their IIM accounts (takes 2-5 days).
	30	MMS accounting system generates second report and same process ensues.

AMENDMENTS TO FOGRMA

Mr. **Yates**. OK. What are you trying to do? You have Indian royalty disbursements and you are trying to have the Congress amend this, as I understand it—and you correct me if you haven't sponsored this amendment. You want to amend the law, section 111(d) and say "[t]he Secretary shall pay interest on all royalty funds identified as Indian funds and deposited to an aggregate Indian allottee or tribal revenues account but not disbursed to, or made available for disbursement to, a tribe or an individual allottee . . ."

You know the amendment I am talking about, don't you?

Mr. **Bettenberg**. I am very familiar with it, Mr. Chairman.

Mr. **Yates**. All right. And you say in that amendment that the reason for it is because time doesn't permit you to add here to the Act, to comply with the Act because you are supposed to pay the Indian allottees within the same month as you get payment, right? So you want to be able not to pay the allottees, you want to pay the tribes.

He wants to answer that, okay. In just a minute. What you say in the Act is, I assume—I don't know where we got—the lawyer gave me this but I don't know who you gave this to unless it is—we got this from the Interior Legislative Committee.

Apparently in support of asking for this amendment, you suggested that they in their report or in support of the amendment say that, "The Congress rejects the interpretation given to the existing section 104(b) language by the United States District Court for the District of New Mexico."

I happen to have read the decision. I thought the judge was just right in the decision. I thought he was much better than Judge Finesilver was in Colorado as far as the cases before him were concerned.

I, for one, wouldn't want to change FOGRMA in terms of your suggested amendment. You will say if that is true, we will not be able to continue to comply with FOGRMA, will you not?

Mr. **Bettenberg**. Well, we will comply with FOGRMA——

Mr. **Yates**. To the best of your ability, which means you will have to continue to pay interest to the Indians, will you not, because of late payments?

Mr. **Bettenberg**. Would you like for me to answer it as well as you, sir?

Mr. **Yates**. Do you accept my answer?

Mr. **Bettenberg**. No.

Mr. **Yates**. Make it your own answer.

Mr. **Bettenberg**. Mr. Chairman, the interpretation that we had put on FOGRMA, and it is the interpretation that the staff of the authorizing committees say they intended, is that for allottees we should deposit moneys to the Indian trust fund in the very month that we get it.

SHII SHI KEYAH CASE

Now, that takes a substantial amount of effort to do because most leases provide that the money is due on the last day of the month. So what you have is money coming in, often very close to the 4:00 o'clock time limit on the last day of the month. That cash, so long as it is identified in any way to Indians, gets deposited immediately into the Indian allottee or tribal trust fund accounts. It gets deposited, effective the very day we receive it, into the Treasury or into the Indian trust fund accounts in Treasury and starts earning interest under the trust fund.

The judge in the Shii Shi Keyah case said the appropriate Indian account, in his interpretation, meant it had to be deposited into the individual Indian allottees account within the Indian trust fund before the interest would stop running so far as penalty interest under FOGRMA.

We have argued in court that that is physically impossible unless a lessee pays us cash and simultaneously gives us an extensive report on all of the leases for which they owe money. We have to process that through our computer to get the thing tied down to the specific lease.

We have to give that to the Bureau of Indian Affairs that then has to take that particular lease and run it through their computer system to distribute that to the individual Indian allottee.

We think that is not what Congress intended. They did not intend the Federal Government to pay trust fund interest and FOGRMA interest simultaneously during this period when the money was getting transferred into the individual Indian allottee's account.

For that reason we have talked to the authorizing committees, and to the best of my knowledge, have their substantive agreement, although we don't have a timing agreement at this point, that, in fact, FOGRMA needs to be amended if the Shii Shi Keyah case stands.

Now, so far as some of the rhetoric in the letter is concerned, I don't think that there was anything sneaky about it. I have discussed it with the authorizing committees. I, or other people on our staff, have discussed it with the Appropriations staffs. I sent a copy of it and several other suggested possible amendments to every member of our advisory committee, which includes a high official of the Navajo tribe, for instance, and a number of other Indian representatives, most of the states with whom we do substantial business, and industry, for their comment.

I guess I don't know how more open we can be in the process. We certainly weren't trying to sneak anything through.

If so, I wouldn't have written and solicited comments from all those people.

Mr. YATES. OK.

The lawyer's language, I agree with you, is somewhat intemperate. All right.

GAO REPORT

But let me read to you from the GAO report of March, 1986, report No. IMTEC-86-13, the title of which is, "Interior Has Not Solved Indian Oil and Gas Royalty Payment Problems." On page ii, it said, "As of February 1986, the Bureau was not in compliance with the Act's requirements. About 18,000 of 27,000 Indian royalty owners were not receiving information explaining their royalty payments and the Bureau was not providing royalty rate information as required by the act. Also, the explanation statement was hard to understand." You probably are aware of the GAO report.

Now let me go back to May 17, 1982, when Mr. Hodel was testifying before the Senate Energy Committee. In response to Senator Melcher's questions, it bears on the California letter I was reading, Mr. Secretary.

VALUE OF OIL

Mr. Melcher is asking you and he is saying, "What is oil worth today? It is worth $30, I am told, in most fields and if the lease is let under terms where that price could, once contracted for from a given well, automatically escalate as the price of oil escalates, contrary to the contract, the prospective producer may not want to explore and attempt to develop oil or gas in that particular area. It even gets more confusing when you get the gas, since gas quite often from a well which is for . . . the best price you can get for it is $2 or $2.50 . . . depending on where it is and the quantity."

"If you were to apply a measurement that is unrealistic as to what the value should be, we may raise that even though you have got a contract for it. And that certainly should be reviewed on whether or not it would actually cut down on the exploration on Indian and Federal leases."

Mr. Hodel: "As I am sure you are well aware, Senator, we too are very concerned, just as you stated about both production and returns for production and feel strongly that there should be incentives. By the same token, we think that there are these occasional circumstances that get so far out of line it is difficult to see that the Government should be the insurer when we really cannot look into the hearts of the people making that contract in the first instance to determine whether or not it was in fact arms' length."

Senator Melcher: "The arms' length term is relevant here, but you are talking about the possibility of it being some sweetheart type of a contract."

Mr. Hodel: "For instance, sale by the operator to a pipeline company where there is some kind of interlocking arrangement or other arrangements extraneous to this lease which would compensate for the lower price and would be an excellent opportunity, perhaps not even in any corrupt sense, but an excellent opportunity in which a longstanding working relationship would have the effect of cooling a price."

Which that lawyer is contending is what is happening in California, right? That is the point you are making. That could happen, right?

Secretary HODEL. Yes.

Mr. YATES. OK. Then you go on to say, "I don't think we can be in a position of just automatically accepting that price as a measure of our royalty."

That is one of the things we have to look at in these lookback audits. That is why I was asking you about lookback audits, because you yourself liked at least at this time, liked the phrase "lookback audits."

Mr. REGULA. Mr. Chairman?

Mr. YATES. I will yield in just a minute.

To the extent we can and again, records determine this, what is going on in the market is relevant, you say then. And you still think so, don't you?

Secretary HODEL. Sure.

PROTECTING FEDERAL REVENUE

Mr. YATES. What is going on in the market is relevant, but we have to take a look at whether we are properly protecting Federal revenue. I think it is a responsibility I know this committee wants us to have, and I know other committees have certainly insisted we attempt to carry on and attempt to do so.

Mr. Regula.

Mr. REGULA. I think "lookback" is a term that is a red herring. By its very nature an audit is an audit is an audit. I think your question is, the bottom line is, are you making sure the government is getting its fair share——

Mr. YATES. Right.

Mr. REGULA [continuing]. Of revenue? That is the objective of this hearing, to find out where we are.

Mr. YATES. Exactly.

Secretary HODEL. Mr. Chairman?

Mr. YATES. Mr. Secretary.

Secretary HODEL. My views have not changed on the importance of our trying to collect the appropriate level of revenue. In responding to the California letter, we have there, as we have agreed, a letter from someone who has a vested interest in establishing horrendous underpayments. That may or may not be the fact. I submit that will probably not be determined until lengthy litigation has been gone through. Between those two extremes, we try to do the best job we can to determine where we are not being properly compensated. That is not just undervaluation by people who have a cozy arrangement.

Incidentally, the situation I described there would be very hard for us to catch and police, but I am not saying we wouldn't try to do it if we thought we had a case we could make. The case that is easier to make would be—and I have suggested—we look at the possibility of using the definition of arms length that the Internal Revenue Service uses. It has had to deal with what constitutes arms length transactions for years, and I think that is an appropriate place for us to start, at least in determining is this an apparent subsidiary, or is this, in fact, an arms length transaction in valuation. We are trying to look across the board.

I feel that a lot of the questions here this morning have come from the same kind of frustration on your part that I have felt so many times in dealing with this issue.

TRANSFER TO IRS

Mr. YATES. Exactly. That is why I think maybe we ought to take it away from you. Why should you continue to be frustrated? I wouldn't want you to be frustrated.

Secretary HODEL. Mr. Chairman, could I add a couple other bureaus to the list while you are at it?

Mr. Yates. Sure. What others do you want to add? Name them. We are still going to conference.

Mr. Regula. We checked with the Treasury and Post Office subcommittee, and they advise us that by their estimate, the Internal Revenue Service is losing $100 billion a year left on the table each year uncollected. That amounts to about 14 percent loss, considering that they collect $700 to $750 billion. So apparently this is a——

Mr. Yates. This makes them look good then.

Secretary Hodel. Don't transfer IRS to us.

Mr. Yates. That is what they are saying. But Mr. Regula and I—and correct me if I am wrong—we were talking about this as we went to vote, saying without regard to any rancor and without regard to any criticism, what is the best way of handling this? There are hundreds of millions of dollars involved. There are billions of dollars involved. You are frustrated, we are frustrated. We are more frustrated because you did not go into the possibility of looking to some outsider for handling this. I mean, you gave it to your Assistant Secretary a year ago, and he is now starting to tell us he ~~is starting~~ to look at the possibility of another study of a study of the possibility of an outside contractor handling something like that. That was a year ago.

But what is the best way here? I cite you: Quite frequently every Congressman will get a letter from somebody who has some kind of a direct interest in something pending before the Congress. I get this letter from the lawyer who has a direct interest. Sure, he has got a case. But it suddenly occurs to me he is talking about billions of dollars in his case of possible losses to the State of California. He handles the State of California.

If the State of California loses hundreds of millions of dollars as a result of underpricing, shouldn't that raise a flag for you, even though this lawyer has got a vested interest? Doesn't this mean that, sure, you have a vested interest too? Is the state being underpaid? Is the oil being underpriced in that state? That is the question in the lawsuit, and that is a question, that is a decision in which you are interested.

Secretary Hodel. You bet it is. Mr. Chairman, we have gone from the very general, what is the best way, to a very particular, how should we deal with that letter?

Mr. Yates. Not only that letter. How do you deal with your agency? I don't think you are getting anywhere with your agency.

Secretary Hodel. There is a place where I think the record would show, if we could burden the committee and its staff in the kind of detail that we think is appropriate—in fact, I think some of the responses the MMS will provide to the draft report—may I say, I appreciate the fact that you have sent us the draft report and given us a chance to comment on it. We are often confronted with reports which we read about before we have even looked at them. In these days we will try to respond. I have suggested to Mr.——

Mr. Yates. Mr. Regula and I have a pact. We try to be fair occasionally.

Secretary Hodel. Frankly, I feel you have in almost every case been so with me.

Mr. **Yates**. Except in reading that letter with the lawyer that accuses you of being obscene.

Secretary **Hodel**. You were even fair there, sir, in recognizing there he may have been intemperate.

Mr. **Yates**. That is right.

IMPROVED MANAGEMENT OF MMS

Secretary **Hodel**. But the question of the best way is, in fact, I think what we tried to deal with a year and a half ago in Mr. Gjelde's review of the situation; and in coming up with the scoping approach, we did not preclude the possibility of an outside contractor. But what we did conclude was that if we tried in the spring of 1985 to transfer what was then going on to an outside contractor, we had the impossible situation of a speeding locomotive under repair on the track and trying to put a new crew on it. We have already talked about the difficulty of the original transfer from Geological Survey to MMS, and we would have compounded that problem.

We didn't preclude the idea that we ought to seek outside contractors. But what we did say is we have got to try to get the basic data base under control or we can't even hand the controls of this locomotive over to him. Now, that is what we are trying to do. We have fallen behind the schedule. That has been terribly frustrating. I have expressed myself in strong terms internally and have been lulled or placated, whichever word you might choose to use, by assurances that we have made desperate strides on the bulk of the major issues. We still have specific difficult areas to deal with, part of it being the data base.

When that data base comes in, and it is under test now, which is an encouraging sign. May I say, for all our differences with Martin Marietta, they have not walked away from the contract, which would have been extremely difficult for us then to handle, having made the decision to try to complete that. I believe we are closer to a solution than obviously unfortunately you believe we are. I have received probably more assurances from people I work with more closely on that subject, which helps.

But I believe we are making the grade and that when we get this system into place, a large number of the complaints that we are receiving will be dealt with. We are attempting to deal with—what you have raised today here is really a smorgasbord of complaints, and on many of them we have to say we agree. That is a problem, and we are trying to get at it.

Mr. **Yates**. Let me ask you a question.

Secretary **Hodel**. We looked back and said "Why didn't we ask for 50 more auditors sooner?" And maybe we should have.

MMS' ADDITIONAL NEEDS

Mr. **Yates**. Let me ask Mr. Bettenberg the question now. Mr. Bettenberg says now we should have asked for 50 auditors at the time after the hearing. He talked to staff he said. I now ask you, what else do you need? Is 50 auditors all you need to make this an operable program? Mr. Bettenberg?

You are going to have the heavy hand of OMB on your shoulder as you reply and are going to say as a good bureaucrat, and I don't say that invidiously, you are going to tell me there is nothing else we need, Congressman. Again I am putting words in your mouth, am I not?

Secretary HODEL. In answering that question, I don't think Mr. Bettenberg intends to preclude the possibility of coming back tomorrow.

Mr. YATES. Let me ask the Secretary. Why should I ask Mr. Bettenberg? I will ask the Secretary that question. This is your responsibility, it isn't his. I will ask you that question. What do you need? You say you are frustrated. You said you are frustrated by this. What do you need in the way of money to put it on the kind of basis that will ease your frustration?

Mr. REGULA. May I amend your question, Mr. Chairman?

Mr. YATES. Sure.

Mr. REGULA. And include changes in the law?

Mr. YATES. Okay. As long as he has got his druthers, let him answer.

Secretary HODEL. Let me start off by saying this. I think you have suggested the answer Mr. Bettenberg would give. But in giving that, we are not aware today——

Mr. YATES. I don't care for Mr. Bettenberg's answer all of a sudden. I want your answer.

Secretary HODEL. In response to my expressed frustrations, and recently as we were getting ready for this hearing, we discussed this subject again. I am not aware of major areas, and I will have to say major because that is what I expect to hear about—Mr. Bettenberg may have to add to this answer—of areas where we need additional funds. But saying that, I would not want to be precluded from coming back and saying tomorrow, in view of the discussions we have had about this letter, one area we ought to have is somebody or some outsider go look at that issue for us.

Mr. YATES. Do you know what is also part of this problem? It is a frustration for Mr. Regula and for me. We have the Gramm-Rudman law on the books. You have to face the Gramm-Rudman law, and the funds for operations like this are considered discretionary funding. Can we give them what they need, what they need in order to do the job properly? We are going into a conference. The Senate says no, you can't have the 50 auditors, but I am sure that we can persuade the Senators to put in 50 auditors.

But is the arrangement, is the base, is the operation such that under the present circumstances, you can't ask us for the money you need not only for this operation but for your other operations. Because everything you do needs more money in your Department of the Interior. You have had to cut it back mercilessly. We have tried to protect you, but you have still had to cut it back mercilessly.

What can you do here? We give you 50 auditors, that won't do it. I am sure you should have more than 50 auditors in order to protect the obtainable maximum return. I say obtainable, obtainable maximum return. Mr. Bettenberg points out the relationship between the $320 million and $20 million you can collect as a result of hiring those 50 auditors. I asked about 75 auditors. The thing I call the "lookback" audit is what the Inspector General was doing.

Secretary Hodel. Catchups.

Mr. Yates. Yes, a couple years ago, and you are not doing that now. You are not doing that to the extent it should be done, Mr. Bettenberg. You don't have enough resources to do it to the extent it should be done. The Inspector General hired outside public accountants to do it. Your auditors work for you. They have got lots of duties to do. They can't just devote themselves to one single problem. I don't think they can, just as you can't. You should be on this problem, only on this problem, and you can't. You have got too many other duties.

That is why I think we have got to find some place to put just this responsibility of making sure that the government and the states and the Indians are not being gypped. Frankly, are not being cheated—not deliberately, to use your phrase to Senator Melcher. Although sometimes I become suspicious when prices are posted at certain levels. Mr. Bettenberg may be the best intentioned person in the world, but he has got too much to do. He doesn't have enough resources with which to do it. He has got to go over the question of whether we shall provide tracts for leasing out on the California Coast. That is part of your responsibilities too, isn't it, and a major part of your responsibility, isn't it?

Mr. Bettenberg. Yes.

Mr. Yates. Okay. That is a big responsibility too, isn't it?

Mr. Bettenberg. It certainly is.

Mr. Yates. And collections, this other part of MMS is big too, isn't it?

Mr. Bettenberg. Yes, it is.

Mr. Yates. You are a big man, Mr. Bettenberg, but I don't know that you are big enough to handle both of those very important jobs. So, Mr. Secretary, what you have to do and what we have to do is to find some way of establishing a procedure with some kind of a mechanism that will do it. You should have done it when you first came on board.

Secretary Hodel. I think that is what we are doing. Let me say again that when we respond to the report of the committee's investigative staff, I think you will see some points of difference between their view and our view on specific issues, and that we can, I think, appropriately address. I would urge you that if you are looking for another location for this activity that if you create an independent entity to collect this, free them of two things: Federal personnel law and Federal procurement regulations.

We have succeeded in changing a great number of the people charged with audit responsibilities. I think that original statement you read earlier from me about the basic problem of trying to take geologists, who are interested in geology, and make them accountants and collectors is a fair statement, and that is without any meaning to be disrespectful to them. It is just that is not what they signed up for, but that is what they were trying to do.

MMS' IMPROVEMENTS

We have made those changes. We do have auditors. We are making that quality improvement. We will have a computer system here, we believe, which will provide the cross referencing you have to have in order to do what you are asking us to do. We do have an impossible situation with that court decision. But that is only one specific area of problem. If that isn't resolved by the Congress doing appropriate modification of FOGRMA, we are going to continue to do what we are doing well. We'll just have to pay penalty interest on top of other interest.

But there is no way we can comply with that court decision which we think is erroneous. That is the kind of continuing issue that will arise, but that doesn't go to the basic competence of the system, and that is what I think you are frustrated about, as I am. But those are specific kinds of problems we may continue to have forever.

The Internal Revenue Service has an audit problem. They have constant disputes with people they are trying to collect from. We will always have that. That is the nature of it. I don't think we would be in a position today to transfer this system unless you took all the people with it to some place else for better management.

I really do not resist reorganization, Mr. Chairman. As you know, I have supported several before this Congress and I think received—we have never been able to persuade the Congress that one made sense. But I generally think it is not harmful to restructure reporting assignments because people take a new look at things.

Mr. YATES. Well, I think it ought to be either an outside agency or another government agency outside of the Department of Interior.

I don't know how you are going to deal with your trustee relationship to the Indians when you have the BIA and the MMS at odds because BIA is supposed to be fighting you for adequate collecting in order to get—in order to provide the correct amounts to the allottees.

You know, that is a possibly big lawsuit.

LEASE MANAGEMENT

Mr. REGULA. Mr. Chairman, may I ask a couple of questions?

Mr. YATES. You may, indeed.

Mr. REGULA. How many leases do you manage?

Mr. BETTENBERG. About 22,000.

Mr. REGULA. What is the total average revenue annually?

Mr. BETTENBERG. It is going down right now. It hit a high of about $4.6 billion, and my recollection is it is some place between three and a half and four billion anticipated this year.

Mr. REGULA. Of that amount, how much goes to the Federal Treasury and how much to the states and/or Indian tribes?

Mr. BETTENBERG. States traditionally have been getting a little over a half billion. That will fall some this year. The Indians have been getting something over $100 million a year.

Mr. REGULA. So, the bulk of it goes to the Federal Treasury?

Mr. BETTENBERG. The bulk of it goes to the Federal Treasury.

Mr. **Regula**. Do you operate this in a centralized location so when the lease is in New Mexico or Maine or Arkansas, do the reports come to one central location for management purposes?

Mr. **Bettenberg**. They do now, yes. They did not use to before the creation of MMS. They all go to Lakewood, Colorado. Our auditors are disbursed around the country.

Mr. **Regula**. I understand, but the lessee sends the report and the check to a central point.

Mr. **Bettenberg**. That is correct. That has been created in just the last few years.

Mr. **Regula**. So, you are trying to restructure this to get it under control.

Mr. **Bettenberg**. It has been totally restructured in the last five years.

Mr. **Regula**. You require production reports from the lessee.

Mr. **Bettenberg**. We require production reports, per se, at this point within the Minerals Management Service only for offshore leases, solid mineral leases onshore and a suite of companies that are what we call our pilot program onshore.

The production reports for the rest of onshore currently go to the Bureau of Land Management, as it has for a long period of time.

Mr. **Yates**. The information we have is that of the 22,000 leases that he says he has, the figure in the hearings was 25,000 plus on leases. He says 3,767 leases are in the Production Accounting and Auditing System, PAAS, 3,700.

Mr. **Regula**. The balance do not have production report requirements?

Mr. **Bettenberg**. To the Minerals Management Service. The ones that we do get represent some 75 to 80 percent of the revenue that comes in to us.

What I have testified on before, both in the hearings last year and the hearings this year, and in other documents, is that we thought it was appropriate to pause and study before going forward with a production accounting system onshore because the job of converting those leases into the production accounting part of our system—it is only one of our systems—is going to be a gargantuan job, and we wanted to assure ourselves—and it will take a lot of people—and we wanted to assure ourselves before we did that that it was going to be not only a cost-effective approach but the most cost-effective approach.

Mr. **Regula**. How do you ascertain without production reports whether or not you are getting your fair share of the sale from a lease?

Mr. **Bettenberg**. A company at this point sends us their sales information, how much they claim to have sold and at what price and amount to go with it.

At this point, apart from certain kinds of edits that we can run and so forth on our computer, our main reliance is on our auditors for following up, our auditors and the state and tribal auditors to whom we have delegated authority.

Mr. **Regula**. Do you spot check on the audits or do you only respond to complaints?

Mr. **Bettenberg**. We do both. We do sampling kinds of audits. When we find an issue with a particular company, then we are likely to pursue a whole series of other leases on that particular issue.

To give you an example on the take-or-pay type of situation we were talking about before, if we discover a company has gotten some payments under a take-or-pay contract, then we will either do some of our own audits or we will require them to report to us any other payments on that particular issue.

It is a very effective way of auditing, in the minds of our auditors and in the minds of those who have reviewed it.

Mr. **Regula**. You mentioned you had 22,000 to 25,000 active leases. How many lessees? Because obviously one company may have a couple hundred lessees.

How many total lessees do you deal with?

Mr. **Bettenberg**. My recollection is that it is someplace around 1,500 to 2,000 payors.

Now, in many cases we will have one company that is paying on behalf of many other lessees. In El Paso natural gas, for instance, they probably have thousands of interest holders in leases for whom they are reporting payments.

Mr. **Regula**. Do you handle all leases, whether it be the Forest Service, BLM, Indian—wouldn't be any, I assume, on the Natural Parks.

Secretary **Hodel**. No.

Mr. **Regula**. Are all mineral leases, regardless of what agency may have the surface responsibility, handled through your agency?

Mr. **Bettenberg**. To the best of my knowledge, yes. We handle all of those bureaus and, in fact, it is a question that gets at proper organization.

In the MMS we have two responsibilities. One is offshore leasing and the other is royalty management. There is a strong connection between our offshore leasing and our royalty management for the offshore leases.

There is that same relationship between our royalty management people and the Bureau of Indian Affairs, and our people and the Bureau of Land Management.

Mr. **Regula**. But in the final analysis, if I were a lessee and had a lease, with, let's say, the Forest Service, I would still be reporting for purposes of payment and record keeping to MMS.

Mr. **Bettenberg**. That is correct, and BLM would be holding the lease document.

LEASE STANDARDIZATION

Mr. **Regula**. Has there been any attempt to standardize the leases? Because I suspect with 22,000 leases there is a great variety of ways in which they are constructed which makes it even more difficult to manage and/or audit.

Mr. **Bettenberg**. Most of them are standardized. There are certainly exceptions to those, some historic.

For instance, a number of our offshore leases were obtained through the Supreme Court settlement with Louisiana back in the late 1940's or early 1950's. Indian leases are tending more and more to be nonstandard, which is another one of the many issues that we are dealing with right now.

In fact, they are not subject to having an automated accounting process.

Mr. REGULA. Do they negotiate their own leases or do you negotiate them on their behalf?

Mr. BETTENBERG. The leases are typically negotiated by the Indians. The lease has to be approved by the Bureau of Indian Affairs.

We have instituted a procedure whereby the Bureau of Indian Affairs notifies us of the requirements of the lease before they approve it so that we can assure that it is going to be an auditable lease.

They should not only be auditable but the record should be retained for an adequate period of time. One of the things we discovered on the nonstandard leases was that a number of them apparently have provisions for record keeping that only go two years or four years, and so we are doing some catch-up auditing on those to make certain that we don't lose the audit trail before the time runs out.

Mr. REGULA. Are there any criminal penalties available for a lessee underreporting, and if so, have you had any instances where you have filed actions of that nature?

Mr. BETTENBERG. There are, but they are probably unworkable. The way the law is set up, you have to give notice of noncompliance.

Mr. REGULA. You mean the Department does?

Mr. BETTENBERG. The Department does.

So one of the thoughts we had in one instance was we should absolutely require that somebody put their account on their check, and if they don't, we will hit them with a penalty.

Then we realized that that is kind of silly, because we are not going to send the check back to have them put something on it. We put that into the Treasury as rapidly as possible.

Mr. REGULA. Sounds like myself.

Mr. BETTENBERG. So if we notify a company that they have misreported, then we have to give them the period to correct. And they traditionally do.

I am only aware of one set of falsified reports ever received by the agency. We have found some underreporting, but my auditors have advised me they have not yet run into one that they think we have any kind of a prosecutable case.

It doesn't mean there aren't some out there, but our auditors haven't found them yet.

CHANGES TO FOGRMA

Mr. REGULA. You mentioned some changes, Mr. Secretary, in FOGRMA that you think would make it more workable. Have you suggested these to the authorizing committee?

Secretary HODEL. I was referencing the dialogue that occurred previously between the Chairman and Mr. Bettenberg with respect to the payment of penalty interest on failure to pay.

Mr. REGULA. That is just one. There are probably others.

Mr. BETTENBERG. We have, as I recall, two before Congress, but it doesn't look like we will get any action on them this year, that are formally before Congress.

We have discussed others in the same documents that I referred to that we had discussed with the authorizing committee staff and had sent out to the advisory committee members for their review.

There are some improvements that could be made.

Mr. **Regula**. Thank you, Mr. Chairman.

Mr. **Yates**. Let me move to another subject.

How much time do you have?

Secretary **Hodel**. I am willing to stay here.

Mr. **Yates**. Be glad to buy you a sandwich.

Secretary **Hodel**. I have a commitment, but I don't want to walk out or suggest I am trying to walk out on this hearing. This is a rare opportunity.

Mr. **Yates**. In order to protect you, I will demand that you stay here, Mr. Secretary, and answer some questions.

You wrote me a letter in response to a letter. Do we have the letter I wrote? I think both should go into the record.

On blank day to be filled in, I addressed a letter to you on the—August 8, 1986. I wrote a letter to you respecting the settlement that you approved in the case of TOSCO versus Hodel on the question of——

Mr. **Regula**. Would you yield for one more question?

You mentioned you centralized the management. Is it in Washington?

Mr. **Bettenberg**. It is in Lakewood, Colorado, which is a suburb of Denver.

TOSCO V. HODEL

Mr. **Yates**. In this letter that I wrote to the Secretary, which may go into the record at this point to be followed by the Secretary's reply to me, dated September 22, 1986, with the attachments to the Secretary's reply, in my letter I said this, "Articles in the Rocky Mountain Review indicate that Interior staff admits the estimated value of the disputed lands to be $2,000 an acre."

"The settlement would exchange the oil shale, sand and gravel rights for $2.50 per acre. While existing surface rights will be maintained by the Government, these dubious claims have been honored at what appears to be a substantial loss to the federal government."

Okay. The letter speaks for itself. The Secretary's reply encloses a memorandum signed by Mr. Griles, the Assistant Secretary for Land and Minerals Management, together with a copy of his testimony dated August 12, 1986 before the House Committee on Interior and Insular Affairs on the disposition of pre-1920 claims to oil shale lands.

[The information follows:]

SIDNEY R. YATES
9th District, Illinois

COMMITTEE
APPROPRIATIONS

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Related Agencies

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Washington, DC 20515

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(312) 353-4596

3100 Ridge Avenue
Evanston, IL 60204
(312) 328-2610

August 8, 1986

The Honorable Donald P. Hodel
Secretary
U.S. Department of the Interior
18th and C Streets, N.W.
Washington, D.C. 20240

Dear Mr. Secretary:

Reviewing the settlement agreement prepared as recourse to further litigation in the _Tosco v. Hodel_ case has raised several points of concern.

Articles in the _Rocky Mountain Review_ indicate that Interior staff admits the estimated value of the disputed lands to be $2,000 an acre. The settlement would exchange the oil shale, sand and gravel rights for $2.50 per acre. While existing surface rights will be maintained by the Government, these dubious claims have been honored at what appears to be a substantial loss to the federal government.

You advertise that the settlement encourages oil shale development by restricting claimant's non-oil shale activities on the surface area for 20 years. Oil extraction from oil shale is not presently thought to be commercially viable and the "claimowners" have made no commitment to undertake oil development on this land. These oil shale reserves do have a potentially great future value with the development of technology and increased demand for oil. After twenty years, the settlement frees the claimants to develop the land commercially which interferes with future oil shale development.

Beginning with _Freeman v. Summers_ and continued in _Andrus v. Shell_, the criteria established for the settling of pre-1920 oil shale claims, arguably, has been based on error. Adequate protection of the national interest requires that a sound basis for evaluating such claims be established. While the proposed settlement goes far in nullifying the Finesilver decision, a full-scale and complete appeal would better serve the country.

Though this settlement applies to 80,000 acres, an additional 240,000 acres remain in various stages of litigation.

The Honorable Donald P. Hodel
Page 2
August 11, 1986

By offering a settlement as an appeal you are setting a costly precedent.

I strongly oppose the announced settlement and I urge you to make full appeal.

Sincerely yours,

Sidney R. Yates

SIDNEY R. YATES
Member of Congress

THE SECRETARY OF THE INTERIOR
WASHINGTON

SEP 22 1986

Honorable Sidney R. Yates
House of Representatives
Washington, D.C. 20515

Dear Mr. Yates:

Thank you for your letter of August 8, 1986, expressing interest in the disposition of pre-1920 mining claims located under the Mining Law of 1872 for oil shale in Colorado.

As you know, a hearing on this matter was held by the House Committee on Interior and Insular Affairs on Tuesday, August 12, 1986. The Assistant Secretary for Land and Minerals Management testified on behalf of the Department, and I am enclosing a copy of his testimony for your information.

I asked the Director, Bureau of Land Management (BLM) to look into this matter, and his response concerning the historical background leading to the law and litigation is enclosed.

If we can provide further clarification on this issue, please do not hesitate to contact me.

Sincerely,

Donald Paul Hodel

DONALD PAUL HODEL

Enclosures

IN REPLY REFER TO

United States Department of the Interior

BUREAU OF LAND MANAGEMENT
WASHINGTON, D.C. 20240

Memorandum

To: Secretary

Through: Assistant Secretary, Land and Minerals Management

From: Director, Bureau of Land Management

Subject: Response to Chairman Yates Inquiry regarding Tosco settlement

The settlement of August 4, 1986, concerns 525 oil shale mining claims covering approximately 82,000 acres in the Colorado portion of the Green River Formation. The claims were located between 1916 and 1920 before passage of the Mineral Leasing Act of 1920 which changed national policy regarding disposition of oil shale and certain other mineral resources on public domain lands. However, the Act specifically stipulated that oil shale claims located prior to enactment of the 1920 Act would continue to be governed by the Mining Law of 1872. One of the provisions of the Mining Law which has remained unchanged since 1872 is the payment by the claimant of $2.50 per acre as a condition for receiving a patent (30 U.S.C. 37). Congress has not given the Secretary any authority to increase this payment.

The first oil shale patents were issued in 1920 by the Wilson Administration and from then until 1960, successive administrations issued patents for 2,326 oil shale claims for the statutory $2.50 an acre fee, covering approximately 350,000 acres. At the same time, other oil shale mining claims began establishing a lengthy legal history. In fact, during this period, two oil shale cases reached the Supreme Court. The Court twice rejected the Department of Interior's efforts to invalidate claims for alleged non-performance of annual assessment work. From 1935 to 1960, the Department issued patents for oil shale claims without further challenge.

In 1961, Administration policy changed and efforts began to repudiate the settled rulings and practices of the previous 40 years. This set in motion 25 years of thorough and comprehensive litigation of which the cases before Judge Finesilver were the latest.

One of the more significant decisions during this period was issued by the Supreme Court in 1980 (Andrus v. Shell Oil Co., 446 U.S. 657 (1980)). Here, the Supreme Court ruled that Congress declared oil shale deposits to be valuable mineral deposits in the savings clause of the Mineral Leasing Act of 1920 (30 U.S.C. 193). Therefore, oil shale mining claims are patentable despite the lack of present marketability, that is, despite the fact that extraction of oil from oil shale is not now commercially viable. While Chairman Yates has characterized this decision as "based on error," the Department, as well as the Federal Courts, are bound by decisions of the Supreme Court and we have no reason to expect a different result in a new case.

It must be emphasized that the settlement is fulfilling an obligation to a mining claimant--an obligation mandated by the Congress of the United States under the 1872 Mining Law. The Department's action in this instance is non-discretionary and once a mining claim is determined to be valid, the claimant is entitled to a patent for the land encompassed by the claims. In fact, the claimant is entitled to a patent with no limitations attached to it or its use, which takes that land out of Federal ownership entirely and makes it private property in every sense.

In this settlement, the United States and the State of Colorado, as well as countless individuals, receive significant benefits in return from the claimants. These types of benefits are not normally retained in the patenting process. Under the Court decision, the government and the general public would get nothing if we had not negotiated the settlement agreement. The agreement provides for the Federal Government to retain all oil, gas and coal. Valid existing rights-of-way are preserved. Hunting and access to hunting areas are recognized. Federal grazing lessees are allowed to continue grazing under the terms and conditions of their existing leases. State water rights are not affected.

The settlement also will result in limiting the impact of the District Court decision from being applied to other locatable minerals under the 1872 Mining Act, as well as other pending oil shale claims and ends 25 long years of litigation.

In summary, an appeal of the District Court decision was a very high risk proposition where the government and the general public could lose everything. What we gained through the settlement process served the public much better, and we felt that the settlement was the most reasonable and responsible alternative.

Acting

AUG 12 1986

STATEMENT OF J. STEVEN GRILES, ASSISTANT SECRETARY, LAND AND MINERALS MANAGEMENT, DEPARTMENT OF THE INTERIOR, BEFORE THE COMMITTEE ON INTERIOR AND INSULAR AFFAIRS, UNITED STATES HOUSE OF REPRESENTATIVES, ON THE DISPOSITION OF PRE-1920 MINING CLAIMS TO OIL SHALE LANDS.

Mr. Chairman, Members of the Committee. Thank you for this opportunity to discuss with you the settlement of the TOSCO Oil Shale case which resolves a 66 year dispute over numerous oil shale claims in the State of Colorado.

To be very honest, we are surprised at the negative reaction of some to this settlement and we can only surmise that people interested in protecting the public interest, as is the Department of the Interior, have not received correct information on this settlement. It is unfortunate that some individuals have prejudged this settlement without adequate knowledge. We are grateful for the opportunity to correct a number of misconceptions that have been publicly debated.

The agreement provides:

- On all land transferred, the Federal Government retains all oil, gas and coal, including a currently producing oil and gas field.
- Valid existing rights-of-way are preserved.
- Hunting, and access thereto, are preserved.
- Federal grazing lessees are allowed to continue grazing under the terms and conditions of their existing leases.

- State water rights are preserved. BLM will relinquish its claims now pending with the State for water rights and the claimants will have to file under State law for any future needs.

We would like to point out the many advantages to the public from the settlement:

- First, the settlement resolves a long-standing legal battle with a minimum loss to the Federal Government when compared with the ultimate risk of losing the case in its entirety, in light of numerous adverse court decisions.

- The settlement gives to the United States the existing and future oil, gas and coal rights of the Federal Government on 82,000 acres with the right to lease those minerals and collect and disburse royalty revenue, not only for the Federal Government but also for the State of Colorado.

- As a result of this part of the agreement, the State of Colorado's 50 percent share of all oil, gas and coal mineral leasing royalties is protected.

- A potential trespass action by the claimant for oil and gas revenues, were they to receive full title, is avoided.

o The settlement extends the public use of the surface area of 82,000 acres in Colorado and includes a commitment that future grazing, hunting and use of existing rights-of-way will be allowed.

o The settlement, by continuing existing uses and existing Federal oil and gas leases, minimizes the risk of litigation by those users.

o By restricting the claimants' non-oil shale activities on the surface area for 20 years, the settlement maintains the integrity of the initial claim that was for oil shale and which has the effect of encouraging oil shale development.

o By removing the contested lands from Federal ownership the settlement reduces the amount of Payment-in-Lieu-of-Taxes due from the United States. The State would then be free to tax the privately held lands, which should result in greater revenues.

o The settlement preserves State water rights. As I said, the Bureau of Land Management will relinquish its claims now pending with the State for water rights and the claimants will have to file under State law for any future needs, as it would with any surface title transfer.

o By discontinuing appeals on the patents, substantial legal fees will be saved. Had the appeals continued, the Departments of Justice and the Interior would be continuing to commit both manpower and dollars to a seemingly endless process.

- And finally, the settlement limits the impact of a very unfavorable district court decision from being applied to other locatable minerals under the 1872 Mining Act as well as other pending oil shale claims.

As part of the agreement, the claimants will receive a patent on their claim which grants them the fee title to the surface area, and the rights to the oil shale and the sand and gravel. Simultaneously the claimants will issue a special warranty deed to the United States conveying title to the oil, gas and coal.

We think that the following historical review of this issue will be of assistance in understanding the basis of the settlement:

- The settlement covers certain oil shale mining claims, presently under patent application, located prior to 1920 under the 1872 Mining Law in the state of Colorado. The 1872 Mining Law provides that a claimant is entitled to a patent of the claim if the claimant has located and maintained the claim, and proved a discovery. A claimant who meets these requirements is entitled to apply for and receive a fee patent of the claim upon the payment of $2.50 per acre.

- In the 1930's, the Supreme Court twice reversed efforts by the Department of the Interior to invalidate unpatented claims on at least 710,000 acres in Colorado, Wyoming and Utah.

- Between 1935 and 1960, claims covering over 350,000 acres were patented to private parties. In none of these cases was there any reservation of rights to the United States or notice to Congress that the patents were being issued.

- In 1960, the Department reversed its policy of 25 years and revived its efforts to invalidate the remaining unpatented claims on 360,000 acres.

- In 1970, the Supreme Court held that the Department of the Interior could seek to invalidate claims where there was a failure to "substantially comply" with annual assessment work requirements.

- In 1980, the Supreme Court ruled that the Department of the Interior could not invalidate claims on the grounds that oil shale had no present commercial value.

- Judge Finesilver, in Tosco v. Hodel, decisively ruled against the Department on both the discovery and assessment work issues. This represented the culmination of litigation that commenced in 1966.

- Since 1920, the Department has lost on the discovery issue twice in the district courts and once each in the court of appeals and in the Supreme Court, without ever winning a case.

- Since 1920, the Department has lost on the assessment work issue 5 out of 6 times in the district court. 3 out of 3 cases in the court of appeals, with one procedural remand, and 2 out of 3 cases in the Supreme Court.

The Finesilver decision, if left intact or affirmed on appeal, could have future application to mining claims for minerals other than oil shale. When the settlement is implemented, this potential will be removed.

Although a appeal was filed in the subject case, the United States and the claimants also pursued the suggestion in Judge Finesilver's order that "counsel make one last effort to explore settlement without further appeal in this litigation." In addition, the Secretary of the Interior was encouraged to resolve this issue by a 1983 resolution of the Colorado legislature, a copy of which I would like to submit for the record.

This two-track effort - appeal or settle - put the United States in the favorable position of being able to explore every opportunity to settle the litigation without further delay while at the same time assuring an opportunity to prosecute an appeal if settlement negotiations failed.

I want to review the factors that led to the decision to enter into this settlement.

I would simply state that with a history of 66 years of involvement in this issue there has not been a "rush" to judgment by the Department of Interior in this case. In that 66 years were many policy changes and court decisions that may have changed our course of action at times. In addition, the settlement process took over a year. Before entering into this settlement, the officials of the Department of the Interior considered advice to appeal the decision of the court as well as to enter into a settlement. After carefully reviewing offered advice, the potential risks and benefits of further appeal, the risks and benefits of settlement and other pertinent factors, the decision was made to enter into a settlement because:

- The long judicial history of decisions on this subject indicated uncertain prospects of ultimate success on appeal.
- Willingness of the parties to settle offered the opportunity to gain finality to the matter as well as a substantial portion of the estate.
- The need to moot the recent court decision because of its serious adverse implications on other pending mining claims.

I urge you to review all of the material we have and will provide the Committee. Of particular significance are the several court decisions that have gone against the United States. A reasonable reading of the record will show that the appeal route was a very high risk proposition in a matter that generates much emotional response. It is very easy for those who do not like the law or the court's interpretation to say "Appeal until hell freezes over", but for those of us who are responsible for making the decision, we must deal with the real world. What we gained through the settlement process served the public much better than a "high risk roll the dice" appeal.

In the short time we have had to prepare for this hearing we have not been able to comply with all of the Committee's requests for documents relating to this settlement. We are working vigorously to provide the additional material and we will do so at the earliest possible time recognizing the public interest in resolving this issue. I can assure you that the Department will respond with all due haste to answer any additional inquiries or future requests for information regarding the TOSCO settlement, remembering that some of the documents in this matter go back at least a quarter of a century.

In closing, I wish to respond to some of the allegations that have arisen since this settlement was made public.

This settlement is not a "giveaway" in any sense of the word. First, you can not give away something that the law says belongs to somebody else. The courts have ruled several times against the Department's challenges to these claims. More importantly, in this settlement the United States and the State of Colorado, as well as countless individuals, receive significant benefits in return from the claimants. We are getting this even though the claimants had already won in the courts.

Another charge that has been made is that somehow the agreement is morally indefensible.

I do not believe there is anything immoral in complying with the law of the land.

I do not believe there is anything immoral in complying with the decisions of the courts.

I do believe there may be something immoral or at least impolitic in pouring the inexhaustible resources of the United States into appeals which have an uncertain prospect of success.

The Department of the Interior is not, as some have charged, selling lands at bargain prices based on some "fire sale" policy. This is not a sale of lands. It is fulfilling an obligation to a mining claimant - an obligation mandated by Congress. By law once a mining claim is determined to be valid, the claimant is entitled to a patent. He is entitled to a patent with no limitations attached to it. Under the settlement we negotiated based on numerous court decisions, including several in the Supreme Court, we are fulfilling the requirements of existing law in recognizing the rights of individuals that are spelled out in laws. We will issue patents for certain mining claims at $2.50 an acre, the price specified by the 1872 Mining Law for those who fulfill the requirements of that Act. But more importantly, we, the people of the United States, are getting valuable benefits not normally given us when a patent on a mining claim is issued.

In closing, I would be pleased to answer your questions. There is no question in my mind that after you have reviewed the testimony in today's hearing, and the stacks of documents we are providing, you will see the wisdom of our decision to enter into a settlement of these cases.

Mr. YATES. The Secretary, in his letter to me, says, "As you know, a hearing on this matter was held by the House Committee . . . . The Assistant Secretary for Land and Minerals Management testified on behalf of the Department, and I am enclosing a copy of his testimony for your information."

Well, I looked at the testimony of the Assistant Secretary, and one of his conclusions, I guess in reply to questions that must have been asked of you under him as to why you acted so quickly, and he says here in reaching the settlement, he replies in his testimony, "I would simply state that with a history of 66 years of involvement in this issue there has not been a 'rush' to judgment by the Department of Interior in this case. In that 66 years were many policy changes and court decisions that may have changed our course of action at times."

"In addition, the settlement process took over a year. Before entering this settlement, the officials of the Department of the Interior considered advice to appeal the decision of the court as well as to enter into a settlement."

"After carefully reviewing offered advice, the potential risks and benefits of further appeal, the risks and benefits of settlement and other pertinent factors, the decision was made to enter into a settlement because . . ."—and that is listed here, and of course, this is going into the record.

The reason that, again, I am frustrated, Mr. Secretary, and piqued, is the testimony of your Department before this committee says you are not going to appeal the case. There was nothing between that advice to this committee and the settlement as far as I know where you notified Congress of your intention to make a settlement of the case.

For example, justification for the Office of the Solicitor for fiscal year 1987, this is part 2 Justification of the Budget Estimates page 1028. He says this. "Three aspects of the mining law are generating significant work: oil shale mining claims; state regulation of mining claimants' and operations and hazardous material liability and usage in plans of operations. With respect to the first," namely aspects of mining law, the oil shale mining claims, "[W]ith respect to the first, fiscal year 1986 will see the prosecution of the appeal of the leading three oil shale mining claim contests, decided adversely to BLM in May and November 1985."

That is the last notice to Congress that I know that was given as to what the intention of the Department was. The next thing we knew, the settlement had taken place. Raising another point for consideration, should we in the future, in order to protect the Congressional review of cases, major cases of this kind, which involve literally hundreds of millions of dollars to the Federal Government and to the taxpayers of the country, should we put a provision into our law which requires that before you can come to a settlement of this kind, you not only have to notify Congress, but get an approval?

Why did you not tell us that you were going to settle the case and give us a chance? I might say that the same thing happened in another way in the Westlands case in California where the House had put a provision in the bill requiring the opportunity for Congress to look at it.

Settlement was made before the Senate had a chance to act on it. I don't know whether the Senate would have accepted the House language. At any rate, it became moot at the time the Senate came to consider it.

That is an important case, too, the Westlands case. That involved the question of millions of dollars in water payments that may affect special privileges and preferences to particular groups of water users.

Do you feel Congress should not have an opportunity to consult with you before you come to judgments as to how to proceed on cases of this type? The oil shale case, I thought, Congress should have been notified before you arrived at your settlement, but again, I let you answer that with your own words.

Mr. REGULA. Mr. Chairman, may I?

Mr. YATES. Sure.

Mr. REGULA. In your question, when you say the Congress, are you suggesting that approval——

Mr. YATES. I am talking about our committee. You do come to us. You do come to us now and ask for approval on sales of real estate. We ask you to have appraisals of the real estate. You come to us on questions of changing your appropriations, of moving your money, which are in the most part pipsqueak amounts when compared to the amount that is involved in the TOSCO case.

I don't know that we should have to do something like this. We do it because we want to be aware of major steps that you are taking and admittedly the real estate transactions for which our approval is sought aren't nearly as important as a case like the TOSCO case or the Westlands case. What do you think?

TOSCO SETTLEMENT

Secretary HODEL. Mr. Chairman, at the risk of finding another area of disagreement with the committee, I genuinely believe that the management of issues like this is not amenable to a long, Congressional review process.

Settlements of litigation are a very difficult and contentious matter. We ask for money, as you pointed out, in order to carry on appeals, because had we not been prepared to carry on the appeal, we couldn't have come to a settlement.

If we had said we plan to settle this so we don't need the resources to carry on the appeal, obviously the other side would have said, we don't have to negotiate with those guys.

Mr. YATES. That isn't necessarily true. You would have asked us for money with which to negotiate with them. If you couldn't come up with an agreement, then you could go forward with an appeal.

Secretary HODEL. In the case of the Westlands matter, if I may take that one first, we were required to submit to the Congress for a 30-day period that document before we submitted it to the court.

We did that. The House acted. The Senate did not act. I think in not acting, the Senate had time—it didn't choose to act—as you and I both know, there are lots of complex matters in issues of that nature. We did submit to the court for its consideration that proposed settlement, which I understand has not yet been concluded.

In the case of TOSCO, as you indicated, this matter has gone on for over six decades, and when we lost—let me say that people often overlook the fact that this Administration pressed the case for four and a half years until we lost before Judge Finesilver in that lawsuit, and we lost a case which in our judgment, after review, we had very little chance of winning on the substantive portion relating to these claims.

We had a couple of other issues which were extraneous to the main holding which we thought we could get reversed, and some of our lawyers thought we should get that done in court. We were able to negotiate a settlement in which the worst aspects of that holding were set aside, and those elements, the extraneous matters, were negotiated out, because they weren't relevant to these plaintiffs.

My view is that for all practical purposes, if it becomes necessary for us to submit settlements relating to these kinds of issues to the Congress for approval during the course of the negotiating process, we effectively will be foreclosed from negotiations.

It is very difficult to carry on a contentious piece of litigation negotiation in a highly public process. Most of the settlements we conduct, for instance Indian water rights cases, require us to come back to Congress for a legislative approval of some aspect of the settlement.

They automatically come to the Congress. The Congress has the full review of them. But the settlement authority is the Attorney General's authority. In this case, we very much actively participated in the negotiations, but ultimately, we had to persuade the Attorney General that he should exercise his settlement authority.

I think in this case, Mr. Chairman, it is a highly defensible resolution of the case, compared to where we were and compared to where we thought we likely would come out on appeal.

CONGRESSIONAL APPROVAL OF CONTRACTS

Mr. **Yates**. You were Secretary of Energy. We have placed in the energy portion of our bill a provision that says, "That any contract, agreement, or provision thereof entered into by the Secretary pursuant to this authority shall not be executed prior to the expiration of 30 calendar days (not including any day in which either House of Congress is not in session because of adjournment of more than three calendar days to a day certain) from the receipt by the Speaker of the House of Representatives and the President of the Senate of a full and comprehensive report of such project, including the facts and circumstances relied upon in support of the proposed project."

Why shouldn't that be applicable to Interior, too?

Secretary **Hodel**. I think it is bad government.

Mr. **Yates**. Okay.

Are any of the claimed lands within the Indian Reservation trust lands?

Secretary **Hodel**. I don't know.

Mr. **Yates**. Suppose they are? What happens to those lands, if they are tribal lands, I would be surprised if they would be included in this.

Secretary HODEL. If they are non-tribal lands, and we are talking about the subsurface—I have trouble even reconciling that, Mr. Chairman.

I would have to find out, because this is a staked claim. If it were, it would have been a prior claim to the creation of the rights surrounding it in the tribe, I would expect.

Mr. YATES. The Indians would lose their land then, if they had filed before the Indians got the land.

Secretary HODEL. If this were a staked claim, the Indians never had the land. This was land subject to an adversarial or subject to a claim under the 1872 Mining Act.

Mr. YATES. Assuming that is true, assuming that they never had the lands, they assumed they had the lands, do you have to make good these lands to the Indian tribes to make them effective by giving them other lands?

Secretary HODEL. I would be very surprised if that were the case, if the reservation were created after the claim we are dealing with, it would seem to me that would not be the case. Sometimes they have always had those contingencies.

Mr. REGULA. The grant to the Indians would be subject to this claim as a prior instrument or obligation and, therefore, whatever disposition is made, naturally they would be bound by it.

Mr. YATES. That is what the Secretary says. The question I was asking is that the Indians may have accepted it in good faith without making a title search. The United States is giving them these acres.

Secretary HODEL. In those cases, Mr. Chairman, the Indians received what was designated by the Congress or a Secretary pursuant to an Act of Congress and title search, or no, they had very little say.

GRAZING ON OIL SHALE LANDS

Mr. YATES. Do you happen to know how much grazing takes place on the lands on which they will be mining shale?

Secretary HODEL. No, but I understand pursuant to our agreement—I suspect it is not a great deal, because these lands are relatively void of water. So it would be dry land grazing and the settlement that we have simply preserves the existing grazing leases pursuant to their terms, which means as they terminate, they will run out.

Mr. YATES. As they terminate, they will run out.

Secretary HODEL. They will not be renewed.

Mr. YATES. Some will expire before others?

Secretary HODEL. Presumably. I am assuming that is the case.

Mr. YATES. For those that expire, the lands then may be leased for greater amounts than the $1.35 per acre?

Secretary HODEL. At that point, the land will be in private ownership. We have reserved, as you know, from Assistant Secretary Griles' testimony, we have reserved rights-of-way and hunting access to these lands which would not have been available under the Finesilver decision.

Under the Finesilver decision, the problem there, Mr. Chairman, was we lost the entire estate, the surface, the subsurface, the rights-of-way, and we had an enormous potential problem.

You have raised a similar problem with regard to Indians, but the enormous problem we had was that we had some leases for oil and gas on these areas, and the Finesilver decision would have taken those from us, transferred ownership to the new owners, and would have raised questions, claims against us for having offered bad title and claims against the producers for not having paid royalty to the real owners and by this settlement, we have eliminated that problem also, which we can say is a benefit.

GEOTHERMAL AREAS

Mr. **Yates**. What about known geothermal areas under 360 acres? How are geothermal resources treated in the settlement?

Secretary **Hodel**. In the 82,000 acres, I am not aware of any geothermal.

Mr. **Yates**. Suppose there are?

Suppose they find geothermal? Does that go to the claimants, too?

Secretary **Hodel**. It could well. Mr. Chairman, I would be very surprised if you had geothermal resources in these areas because of the nature of the lands. If you have flown in that part of Colorado, you can see what we are dealing with is a high plateau which is underlain by a very large amount of oil shale, which is generally not compatible with ground water.

OIL SHALE INTERESTS

Mr. **Yates**. Is my calculation correct, part of the settlement was that the government retained rights to oil, gas and coal, although these rights yield to the claimant's right to the shale when there is a conflict? That is correct, isn't it?

Secretary **Hodel**. That sounds right to me. Yes. It is an oil shale interest.

Mr. **Yates**. An oil shale interest. And if your interest in oil and gas, which you say is preserved, and which Mr. Griles said was preserved interferes with the development of their oil shale, you'd lose your rights then, wouldn't you?

Secretary **Hodel**. I would have to check with the lawyers on that. I have not focused on that partly because at the present time, there is no known way in which the oil shale can be developed, and as you know from the settlement, we required that for 20 years the surface not be utilized in a way that would render them incapable of going forward with the oil shale development, partly as a means of trying to leave that door open for potential oil shale.

A 20-year period would certainly be beyond the normal oil and gas production period.

Mr. **Yates**. I thought some wells went on for 30 and 40 years. Am I wrong in that?

Secretary **Hodel**. I am sure that may well be true, but I think——

Mr. **Yates**. How do you reconcile your ability to go forward with the development of oil and gas with the provision of the paragraph of the Agreement to Settle Pending Litigation Between the United States and the Owners of Certain Oil Shale Mining Claims in Colorado that says this: Number 1.3——

[The information follows:]

1.3 For all purposes, including the commercial development of the minerals located within each of the Subject Claims, the oil shale deposits (and other mineral interests) owned by the Claimowners that are present above the line of demarcation described in Paragraph 4.6 of this Agreement shall at all times be deemed to be, and be entitled to treatment as, the dominant mineral estate vis-a-vis the United States' ~~subservient~~ mineral estate in any oil, gas and coal present within the same claim. The United States' mineral interests, and any surface uses by persons holding mineral leases from the United States, shall be subservient to the Claimowners' dominant rights to use the Subject Claims for oil shale development and all purposes reasonably incidental thereto, including but not limited to, the right to use the Subject Claims for tailings disposal sites, processing facilities, buildings, workmen's housing, roads, power lines, pipelines and water storage, irrespective of whether actual extraction of the oil shale deposits occurs on the Subject Claims or on other lands, including non-contiguous and distant lands. In addition, the Claimowners, in developing their dominant estate, shall not have any obligation to conserve any oil, gas or coal in the United States' subservient mineral estate that is present above the line of demarcation described in Paragraph 4.6 of this Agreement. The subservient mineral estate retained by the United States shall be dominant with respect to uses of the surface unrelated to development of the Claimowners' dominant mineral estate.

Mr. **Yates**. If they moved forward with some kind of—even almost a pretended oil shale development, you can't develop your oil and gas. They say we are developing oil shale here, and they can do that for 20 years, and your claims for gas and oil go down the drain.

They are subservient to the claim owner's dominant right to use the subject right for oil shale and development, and all purposes reasonably incident thereto, including but not limited to the right to use the subject claims for tailings disposal sites.

They can put tailings on your oil and gas lines, processing facilities, buildings, workmen's housing, roads, power lines, pipelines and water storage, irrespective of whether actual extraction of the oil shale deposits occurs.

They don't even have to have oil shale coming out. They can just say, we are considering it. We are considering it.

Mr. **Regula**. Is this for a 20-year period only?

Mr. **Yates**. This gives them the right during the 20-year period to do this.

Mr. **Regula**. Say, after 20 years——

Mr. **Yates**. Then the Government has no interest at all.

Secretary **Hodel**. After 20 years they no longer are restricted in their use of the surface to oil shale activities.

Mr. **Yates**. They could look for oil and gas themselves, can't they?

Secretary **Hodel**. No, we own the oil and gas.

Mr. **Yates**. What can they do at the end of 20 years?

Secretary **Hodel**. At the end of 20 years they can, if they can think of something to do other than looking for oil shale and developing oil shale, they could do whatever that may be.

Mr. **Yates**. Grazing, for example?

Secretary **Hodel**. Grazing, they could do that. That does not convert the surface.

Mr. YATES. Oil and gas. Suppose they find some kind of valuable mineral, geothermal?

Secretary HODEL. Sand and gravel.

Mr. YATES. They could do that?

Secretary HODEL. I believe they could.

Mr. YATES. That is dominant to your oil and gas rights?

Secretary HODEL. I don't know, Mr. Chairman.

Mr. YATES. Well, isn't that something you ought to know?

Secretary HODEL. I am sure that the people involved in this negotiation know that and——

Mr. YATES. Well, you are the Secretary.

TOSCO APPEAL

Secretary HODEL. Mr. Chairman, I didn't negotiate this arrangement. What I did is rely upon people I have confidence in. That this is far to be preferred to where we were. Part of the problem is that the questions you are raising and many of the questions raised about this settlement were raised as if the alternative were the Federal Government owning this land. The alternative was all of these interests, including the oil and gas, immediately belonging to the claimants. That is where we were.

Mr. YATES. Provided that the Appellate Court sustained the——

Secretary HODEL. As has happened in the courts of——

Mr. YATES. Not on these cases though.

Secretary HODEL. On these issues.

Mr. YATES. Not on these cases.

Secretary HODEL. I have a chart which I think illustrates the difference.

Mr. YATES. That chart was attached to Mr. Griles' statement to the Interior Committee. That has already been made a part of the record. But you know, the regional attorney for the solicitor said that you ought to appeal. He told us of course that the solicitor, in the justification said you were going to appeal, but the regional attorney recommended an appeal and you have his opinion. It was lengthy, I don't think I will put it in the record. And interestingly, the solicitor before, Mr. Tarr, Mrs. Horne—was it Ms. or Mrs.—Mrs. Horne, recommended that appeals were made. But no sooner did Mr. Tarr come in than that was reversed. That land decision was reversed. The opinion of the solicitor was reversed when Mr. Tarr came in.

So I am merely making the point to show that there was responsible legal authority for the fact that appeals should be made.

Secretary HODEL. Mr. Chairman, I do not recall the acting solicitor, now Judge Horne, making a recommendation we should appeal the case.

Mr. YATES. I have a copy of that recommendation. We have a copy of a letter that is undated—I assume she has a copy—I assume she signed it. Does anybody know whether she signed it or not?

What we have here, what my statement was based upon, was the case of Mr. Habig, Assistant Attorney General for the Department of Justice. This offer recommends that appeal would be advised to be pursued in the above case for the reasons stated in the attached enclosure. Protected notice of appeal has already been filed with the Court of Appeals for the Tenth District.

I don't have a date on that. I assume when that was handed to me as part of the briefs of the regional solicitor, that this indicated that Mrs. Horne agreed with the recommendation of the regional solicitor.

Secretary HODEL. I would be surprised if that were correct, Mr. Chairman. I suspect what you have there is a draft of a letter that calls for date and signature. It is not inappropriate or unusual for someone to forward a document and say here attached to it is the letter by which you should transmit if you agree with our recommendations.

Mr. YATES. Well, was she asked for an opinion? Did you ask her?

Secretary HODEL. I don't recall.

Mr. YATES. Would somebody ask her for, whose advice did you go on if you didn't go on the advice of your lawyer, whose advice did you go on?

FINESILVER DECISION

Secretary HODEL. We had a session following the Finesilver decision in the Department, and I am sure that the Solicitor's Office was there. I don't know if Mrs. Horne was the person directly involved. She normally would have been. I was briefed on the consequences of the Finesilver case, which was——

Mr. YATES. By whom?

Secretary HODEL. By someone, presumably a lawyer, presumably the Solicitor's Office. And the message was clear; we had had a total loss; we hadn't just lost the case, that we thought was before the judge; we lost some things we didn't think were before the judge. He went beyond what we thought the case even raised. The implications of that were very substantial and I also received a briefing at that time on the history of this case, the five years of litigation and contention over this.

At that point, we concluded that we had no alternative but to appeal, if for no other reason, because of extraneous positions taken by the judge that we thought would adversely affect our administration of the mining law unless we could get some kind of satisfactory settlement. The settlement discussions resulted finally in this proposal.

The regional solicitor, as I understand it, appropriately was asked along the way to prepare the kind of document that we would submit if we had an appeal to make, the best case you can for appeal. What does it look like, and she proceeded to do that, and I have not reviewed that document but the conclusion that was given me at the time of the discussion of this settlement was to compare where we were under Finesilver, realize that our chances of success were very slim on this appeal, especially with the history and with some key questions having been resolved against us by the Supreme Court cases.

We looked at the settlement, which we felt preserved a lot of surface uses and continued federal ownership of oil and gas, which eliminated the major problem, and settled out of the cases these extraneous issues which affect our other activity. At that point, the question is, is it a settlement you ought to make, or is it not? My conclusion was that it was a settlement that we should make.

Mr. YATES. Does this settlement cover all the claims for oil shale in Colorado?

Secretary HODEL. I don't know. No, I think this—may I give my understanding, then if it is necessary, supply a correct answer for the record?

Mr. YATES. Yes.

Secretary HODEL. My understanding is there actually are a few thousand acres involved in these particular claims, and the question is, whether we will apply—I think there are 82,000 acres affected by this settlement out of approximately 360,000 acres overall in these kinds of mining claims. And whether this is all in Colorado, I don't know.

Mr. YATES. Suppose they file suit in Colorado?

Secretary HODEL. The question I am asked, what does this do as a precedent for other settlements. There is no question that we will look to the Finesilver case as some guidance, because it is clear we have lost this case, but many of these cases will have separate and special conditions. What we had before Judge Finesilver was a set of facts. The reason his case was relatively unappealable is that he stated the law relatively correctly, in our view, and then determined how the facts applied. So we still will have the factual determination to make on those other claims and we intend to do that as responsibly as we can.

As I say, we persisted in the pursuit of this case until we lost in such an egregious fashion. We did not think we had a good chance on appeal.

Mr. YATES. But in your letter you said the Andrus versus Shell case aspect is critical there. There were 15 or 20 criteria used. Were they the same?

Secretary HODEL. I can't tell you.

FINESILVER OPINION

Mr. YATES. The Finesilver decision was advantageous to the holder of the claims, wasn't it?

Secretary HODEL. Very. There is a total victory, plus——

Mr. YATES. And the Finesilver opinion has been published widely?

Secretary HODEL. Yes.

Mr. YATES. Do you think that the opinion would encourage oil shale claim holders to get patents?

Secretary HODEL. Absolutely. Let me say that they have been seeking patents all along. I think they will seek to use the Finesilver case and our settlement here as a possible precedent, and we simply have to look at the facts of the case to see whether the precedent does apply.

Mr. YATES. Well, can you deny the applicants?

Secretary HODEL. If there is a factual distinction we can.

Mr. YATES. You felt in this case there was no factual distinction from the cases that you had previously lost?

Secretary HODEL. These cases were the ones before the court, as I understand it.

Mr. YATES. So, I got the impression from Mr. Griles' testimony that your agreement in the case effectively settled all of the cases.

Secretary HODEL. In Colorado.

Mr. YATES. What about other patent claims in Colorado, weren't they——

Secretary HODEL. For oil shale?

Mr. YATES. Yes.

Secretary HODEL. I don't know. Here, subject to being corrected, as I have checked this out, I don't know that there are additional oil shale claims in Colorado. My understanding is we had 360,000 acres remaining out of 700 some thousand that existed back in 1936 when the Supreme Court told the Department of the Interior it was wrong, and it had to issue these patents.

It began issuing the patents, issued 350,000 acres worth of patents, 360,000 to go in 1961 when the Department said no more. We have been in contentious discussions and litigation apparently since. We lost that litigation. My recollection is there are 82,000 acres that were affected here. That would leave 280, roughly, thousand acres to go, and on those we still have to make the factual determination, that the facts in those cases are the same as the facts in the Finesilver case.

Mr. YATES. You are well underway to another litigation, are you not, on those cases?

Secretary HODEL. In the event we disagree with the claimants.

Mr. YATES. In the event you don't, in the event you don't disagree with the claimants, he moves forward and the government loses more money.

Secretary HODEL. No. I am mandated by law, Mr. Chairman, to operate under the 1872 Mining Act and the 1920 Mineral Leasing Act, and these provide the price and circumstances in which we are to issue patent. We have attempted to carry that out. We resisted here where we thought we had a legitimate basis for objecting. We lost, very, very strongly lost. We will now seek to carry out our responsibilities, taking the Finesilver case into account, to the best of our ability. And we won't reach agreement with everybody, undoubtedly somebody will decide to sue us and we may win or lose that case after time.

Mr. REGULA. Is there at this point an appeal pending? Potentially could there be an appeal? Has time run out?

Secretary HODEL. I do not think the court—I don't know that the court has closed the file.

Mr. REGULA. Is the settlement——

Mr. YATES. Which court?

Secretary HODEL. Judge Finesilver and the Appellate Court.

Mr. REGULA. They filed a notice of appeal, if I heard correctly. That notice of appeal is still pending. The settlement has not been finalized, correct?

Secretary HODEL. We have not acted on this settlement.

Mr. REGULA. Mr. Chairman, would you want to be in the position of we as a committee ordering them to appeal it?

Mr. YATES. I would, yes. Would you not?

Mr. REGULA. I don't know.

Mr. YATES. I would. There is no doubt in my mind they ought to be appealing this case. The amount of money involved is staggering and the precedent that this case may make for similar claimants in Wyoming and Utah and a number of other Western States is incredible.

Secretary **Hodel**. May I protest?

Mr. **Yates**. You may, whatever it is.

Secretary **Hodel**. I would hope that before you and this committee would consider such an action, that you would not only look at the legal opinions that you may be interested in reviewing, but also would hear from our Solicitor.

COMPLETION OF SETTLEMENT

Mr. **Yates**. I would be glad to do that, Mr. Secretary. As a matter of fact, the Senate has put a provision in its version of our appropriations bill which will hold up for a period of 180 days the completion of the settlement. The problem with that provision—and I hope that Mr. Regula and I can change it—is that it requires the consent of the party as well as, if I understand the impact of it.

Let me read it so it is not subject to question:

Section 116 of H.R. 5234: "Notwithstanding any other provision of law, no funds appropriated by this Act shall be available for the implementation, by the Secretary of Interior or the Attorney General or any other officer acting on behalf of the United States, of the 'Agreement to Settle Pending Litigation Between the United States and Owners of Certain Oil Shale Mining Claims in Colorado,' dated August 4, 1986, or for the patenting of any other oil shale placer claims located prior to passage of the 1920 Mineral Leasing Act, for a period of 180 days from the date of enactment of this provision, in order to provide a period for Congressional review of this agreement: Provided, That the provisions of this section affecting the aforesaid settlement agreement shall be effective only in the United States Court of Appeals for the Tenth Circuit and the United States District Court for the District of Colorado approve a stay in the cases affected by such settlement agreement for 180 days and the parties to such agreement agree to continue to be bound by such agreement for the 180-day period."

Now, do you think the parties are going to be bound by this agreement? If you represented a party and you had a favorable agreement, what would you do? At any rate, that is the provision I want to see whether or not Mr. McClure will strike and the Senate will strike.

Secretary **Hodel**. I think we can show, I would hope to the satisfaction of you and the members of your committee, we truly, if our lawyers truly believe that our chances of success on appeal of this decision by Judge Finesilver, that related to the ownership of the land were nil, then it is unconscionable for us to continue, after all of these years, with more litigation.

There is something that perhaps you haven't run into, because you have been a member of Congress, Mr. Chairman. When I was still a citizen, I ran into representatives of federal and state agencies who would say to me, we can't make you do this but we can make it so costly for you, because we can go on forever in litigation, that you can't afford to do it.

Mr. Chairman, that is a gross injustice. It is impropriety. It is bad government. My view is——

Mr. **Yates**. I understand many of the holders were some of the biggest oil companies in the country.

Secretary **Hodel**. We truly believe that we—I believe, Mr. Chairman, the principles of justice apply.

Mr. **Yates**. No double standard?

Secretary **Hodel**. I don't think there is a double standard. I have been on the Western Slope of Colorado recently with individuals who were claimants and whose families have been claimants, and they may not live to see the day that these claims come through. I truly believe it would be a gross injustice for this committee to mandate an appeal in a case that we don't think has merit.

Mr. **Yates**. Your lawyer thought it had merit, your regional lawyer thought it had merit.

LEGAL ADVICE

Secretary **Hodel**. Mr. Chairman, I beg to differ. I believe that the Solicitor of the Department is properly the person I should turn to for legal advice. I expect him to be responsible. If a regional counsel has a different opinion, I am going to listen. I did practice law at one time. I am going to listen carefully. If I think the merits are with the Solicitor, I am going to side with him. In this case I am satisfied.

Mr. **Yates**. Is the department policy now that the pre-1920 oil shale mining claims are valid and should be patented?

Secretary **Hodel**. No. It is our policy that we will look at those claims, accept those that are on all fours with this litigation in Colorado, where we feel that that is the law of the case. With other cases, we will look at the merits of the case and still apply the law as we understand it.

Mr. **Yates**. Has the department's policy just been the opposite, that most of the claims aren't valid? Wasn't that your policy for 20 years?

Secretary **Hodel**. The Department tried to resist these for 25 years, beginning in 1961, and pressed this case. For over four and a half years, until we got to the Finesilver decision, which frankly was a surprise to our lawyers.

Mr. **Yates**. Why did not the Congress consider this case? Why didn't you bring this up before Congress? Couldn't we have imposed a settlement or settled some of the questions of law that arise out of the ambiguity in the mining law? We could have straightened that out, couldn't we?

Secretary **Hodel**. I don't know, Mr. Chairman. It seems to me that we are talking about vested rights under the law and the court probably has the jurisdiction over what the Congress meant. You might be able to correct prospectively.

Mr. **Yates**. Who are the parties to the settlement?

Secretary **Hodel**. I can't tell you.

Mr. **Yates**. Exxon, Phillips are among those?

Secretary **Hodel**. I would expect to find major oil companies among the claimants as well as individuals.

Mr. **Yates**. Thank you for coming.

Secretary **Hodel**. Mr. Chairman, I appreciate the chance to be here.

Mr. **Yates**. Thank you.

[Committee note.—Subsequent to the hearing the Secretary requested that the following information be provided for the record:]

THE SECRETARY OF THE INTERIOR
WASHINGTON

OCT 1 1986

Honorable Sidney R. Yates
Chairman, Subcommittee on Interior
and Related Agencies
Committee on Appropriations
House of Representatives
Washington, D.C. 20515

Dear Mr. Chairman:

Your September 11, 1986, letter requested information on a variety of royalty management topics. I am enclosing a response to your inquiry from the Director of the Minerals Management Service (MMS). I have reviewed his memorandum and found it to be informative. I also think it demonstrates that substantial progress has been made by MMS on a number of topics you raised at the hearing last week. I would appreciate it if you would make the response a part of the hearing record, since we had little opportunity to report on our progress during the hearing.

Your letter also asked for comments on a preliminary report on royalty management matters prepared by your investigative staff. That response is being prepared and will be forwarded by separate cover when completed.

Sincerely,

Donald Paul Hodel
DONALD PAUL HODEL

Enclosure

United States Department of the Interior

MINERALS MANAGEMENT SERVICE
WASHINGTON, DC 20240

SEP 30 1986

Memorandum

To: Secretary

Through: Assistant Secretary - Land and Minerals Management J Steven Griles

OCT 1

From: Director, Minerals Management Service Wm D Bettenberg

Subject: September 1986 Letter from Chairman, Subcommittee on Interior and Related Agencies, House Committee on Appropriations

I have reviewed the subject letter which inquired about the status of a number of aspects of the Royalty Management Program (RMP) and forwarded a draft report on the RMP prepared by the Committee's Surveys and Investigative Staff. Our response to the draft report will be forwarded separately. This is to provide you with summary information in response to specific questions raised in the Chairman's letter. I have also attached a more detailed discussion of each topic prepared by the Royalty Management staff in Lakewood.

Status of Martin Marietta Data Systems Contract

Martin Marietta Data Systems (MMDS) has completed conversion of the Auditing and Financial System (AFS) code, replaced VAX foundation software, redesigned the AFS data base, and completed various unit and integration testing modules. MMDS is progressing with the overall system test. This is the final stage of contractor testing and the basis for certifying the system to the Government for acceptance testing. A further slippage of the AFS conversion occurred recently, however, when MMDS failed to meet its September 15 schedule for completing system testing. The Government has not yet been provided a new completion date or a full explanation of the delay. Our technical staff's estimate is that MMDS will need 1 to 3 additional months to complete its portion of the project. I am meeting with MMDS officials this week to review the status of the testing effort.

Status of RMP Audit Program

The RMP Royalty Compliance Division has completed audits of about 2,400 Federal onshore and offshore leases and almost 1,300 Indian leases since the program's inception in 1981. Audit accomplishments continue to be impressive with approximately $111 million in additional revenues collected or refunds denied during FY 1986, bringing program totals since inception to about $320 million. Accomplishments under the joint audit programs conducted with States and tribes are also noteworthy; $46 million of the $320 million is attributable to this program. The RMP is currently developing an audit strategy designed to audit the lease universe over a 6-year cycle based on sampling and other selection techniques.

Status of RMP Indian Lease Audits

There are currently about 4,600 Indian leases held by 21 tribes of which about 25 percent have been audited by the RMP. Amounts collected from these audits total $13.4 million in additional royalties and late payment charges since program inception. In January 1986, MMS in conjunction with the Bureau of Indian Affairs (BIA) implemented a new joint Indian Lease Audit Strategy to facilitate the resolution of inquiries and expedite audits of Indian leases. Audits have been initiated on 40 Indian leases as a part of this strategy. Special emphasis has been placed recently on nonstandard Indian lease agreements. A total of 38 such agreements have been identified with audits initiated by RMP on 12 of these agreements. An additional $255,000 in revenues has been collected as a result of these nonstandard lease audits.

The Royalty Compliance Division estimates that about 29 percent of its auditors (of a staff of 128) are currently working on Indian leases. The reference in the Chairman's letter to having "corrected" an estimate of 28 auditors to 8 was apparently a transcription error on someone's part. What I said in the hearing was "We have 20-some who are dedicated exclusively to Indian matters right now, 28." The transcript was edited to replace the "0" and the word "some" with an "8." The transcript was subsequently revised to incorrectly also drop the "2."

Status of the RMP Assessments and Civil Penalty Process

As you are aware, MMS has been implementing an enforcement and penalty strategy to further promote and encourage prompt and accurate royalty reporting and payment. The principal elements of this strategy are interest charges for late payments and underpayment of royalties, assessments of liquidated damages for erroneous and late reporting, and civil penalties for those payors who fail to properly report and pay to the AFS after due notice by MMS. The AFS module for automated exception processing was implemented in February 1985. Interest collection since that time has been $1.7 million for Federal leases and about $600,000 for Indian leases. The RMP has issued 739 bills to payors for erroneous reporting totaling $417,000. Another 1,700 bills to payors have been issued in the amount of $1.3 million for instances of late reporting or failure to report.

Pursuant to law, civil penalties are imposed only after a payor has been provided with an opportunity to correct a violation of reporting and payment requirements. Failure to respond results in a Notice of Noncompliance explaining the violation and outlining the remedies expected. If correction does not occur within 20 days from the date of the notice, the civil penalty automatically goes into effect. The first notice was issued in September 1984 and since that time civil penalty notices have been issued to 15 other payors. It is noteworthy that a number of other payors facing potential civil penalties corrected their violations after they were contacted by telephone prior to issuance of penalty notices and encouraged to comply.

In August 1986, the AFS reporting error rate was less than 5 percent for the first time since the AFS became operational. Our accounting staff indicate that this is attributable in large part to the fact that we have been implementing our enforcement strategy by requiring problem payors to correct their reporting and payment inconsistencies.

Contract to Perform AFS Exception Processing

Funding to obtain contract support to perform exception processing verification was initially provided in the FY 1986 budget which was approved in December 1985. The engaged contractor (International Business Services) began hiring personnel for this work in January 1986 and now has 49 employees working on issuance of bills for exceptions. Of those, 39 are working on Federal lease exceptions and 10 are assigned exclusively to Indian lease exceptions. This supports a current MMS staff of 7 assigned to the exception processing program. With the assistance of this contract support, MMS has now collected about $11 million through August 1986. Another $5.4 million has been billed for which bonds have been posted pending appeal.

Status of the Explanation of Payment Reports to Indian Allottees

Before implementation of the Federal Oil and Gas Royalty Management Act of 1982 (FOGRMA), Indian allottees (as well as tribes and States) received no explanation of their royalty payments. The MMS has provided explanation of payments (EOP) reports to Indian tribes and to BIA for their use in providing similar information to Indian allottees since October 1983. While MMS did consult with Indian tribes and BIA before designing the EOP reports, it has been known for some time that the reports need to be restructured for clarity and provide additional information. As a temporary measure, special reports have been developed to overcome some of these problems. In the longer term, MMS plans to implement several enhancements to the AFS to provide a more informative explanation of payments to Indian tribes and allottees. It should be noted that this requirement, though reasonable, was not incorporated in the original AFS design, because it stemmed from FOGRMA.

The BIA is also in the process of improving its current EOP to Indian allottees with implementation scheduled for the end of October. Of particular concern to the Chairman is the fact that the Indian EOP statements do not include production information, which is one of the requirements of the FOGRMA. What is provided is the sales volume upon which the actual royalty calculation is based. Production can vary from sales because of inventory changes. Production information is attainable through the Production Accounting and Auditing System (PAAS) which is now operational, but only for offshore mineral leases and a small portion of onshore leases. As you know, the Department is studying the feasibility of expanding PAAS coverage to additional onshore leases.

I trust the information I have provided will prove helpful to you in responding to the letter from Chairman Yates.

STATUS OF MARTIN MARIETTA DATA SYSTEMS CONTRACT

BACKGROUND: The principal benefit of converting from Digital Equipment Corporation VAXs to the IBM mainframe computer will be to allow the Royalty Management Program (RMP) to operate all application software as designed, faster, and more efficiently. It will also be easier to modify and improve existing application software once it is on the IBM; and data extraction and manipulation will be far easier because of available systems software.

- Activity under the fixed price contract with Martin Marietta Data Systems (MMDS) began on April 22, 1985.
- The contract as executed covers the procurement and installation of hardware and system software and the reimplementation of the Auditing and Financial System (AFS) from a multiple VAX environment to a single IBM 3081 environment.
- The reimplementation was originally scheduled to be completed for AFS in 1 year, including 4 months of Government testing, or by May 1, 1986.
- The fixed price for reimplementation of AFS including manuals, training, and support is $4.2 million, and the cost for hardware and system software through FY86 is $4.6 million.

STATUS AND DISCUSSION:

Hardware and System Software Installation.

- Installation of the IBM 3081 GX system with 32 megabytes of memory and 35 gigabytes of storage was completed on July 26, 1985.
- The hardware acceptance test was successfully completed in December 1985.
- The systems software acceptance test was successfully completed in February 1986 after the testing of 46 individual software packages.
- The IBM system has been operational since September 15, 1985, in support of the AFS reimplementation effort and State and Tribal Support System (STATSS) development and production.

AFS Conversion Milestones. In response to the Government's Request for Proposal (RFP), MMDS proposed conversion of AFS application code, reimplementation of the data base, and complete replacement of the proprietary VAX foundation software. The application code was broken into 17 logical groupings called work packages which were processed in two phases: preparation and conversion/unit testing.

- The work package preparation phase including documentation review, recompilation of baseline source code and generation of test data and results on the VAX was completed on February 2, 1986.

- The work package conversion phase which involved conversion of VAX-COBOL to IBM ANSI COBOL and unit testing of individual programs was completed and all work packages accepted by MMS on July 3, 1986.

- The replacement of VAX foundation software, an identified high risk area, was successfully prototyped in September 1985 and all routines have currently been unit tested.

- The three VAX data bases have been reimplemented to a single IBM data base and software to transfer the data has been developed, tested, and is in use.

- Initial drafts of all but one of the required manuals documenting the system have been produced and reviewed by RMP.

- Integration testing by MMDS which tested various programs combined into runstreams was completed in mid August 1986. About 180 problems were detected by MMDS and corrected. Review of test results by RMP has been completed.

- It should be noted that, despite delays and problems with initial quality control on certain deliverables, the final quality of the intermediate products accepted to date has been satisfactory.

- The final conversion phase, currently being executed by MMDS, is system testing which is testing of all programs strung together to form the final production system. This is the final contractor test to validate that the system meets all functional requirements and is the basis for certifying the system to the Government for acceptance testing.

Government Acceptance Testing. Once the reimplemented AFS system is certified by the contractor as completed and tested, RMP begins its independent verification and acceptance of the software. This verification, which is stated in the RFP to take 4 months to execute, consists of a functional acceptance test, a performance test, and a parallel operations test.

- The functional acceptance test entails the rerunning of the last VAX baseline regression test on the IBM and comparing results.

- The performance test will consist of running AFS production data on the IBM system to simulate the RFP stated workload requirements while measuring system performance. The test procedures and custom software necessary to run this test have already been developed and tested by MMS.

- The purpose of the last Government test, parallel operations, is final verification of functional equivalence and transition to operations under actual production work load.

AFS Reimplementation Delivery Schedule. The reimplementation delivery schedule has been extended by MMDS three times and a fourth extension is imminent. The schedule extensions and their principal causes are as follows:

- In October 1985, MMDS informed the Government of a delay in the date for delivery from December 1985 to May 1986. This delay was attributable to slow project startup and MMDS difficulty with work package preparation and conversion.
- In May 1986, MMDS informed the Government of a further delay in delivery of the AFS to late June 1986. The delay was attributable to additional time needed by MMDS to complete conversion of certain difficult work packages and test the system.
- Problems with integration and system testing led to notification in July of a third delay to September 1986.
- MMDS has now passed the current scheduled delivery date of September 15, 1986. However, on September 8, 1986, MMDS verbally notified MMS that they had decided to expand their system test to a mutually agreeable level and that a confirmation letter would be forthcoming. The MMDS Test Team has commenced work on the expanded test.
- MMDS has not provided a new completion date. MMS estimates MMDS will need 1 to 3 additional months, which would delay operation start-up on the IBM until March to May 1987.

IMPACTS OF CONVERSION DELAY. Slippage in the schedule to date has caused MMS to revise its plans due to functional and operational impacts as follows:

- Delay in reassigning Operations and Maintenance (O&M) responsibility for PAAS and BRASS from American Management Systems (AMS) to either MMDS or International Business Services (IBS) has caused the AMS contract to be extended.
- Delay in moving one VAX to the Denver Federal Center and returning one VAX to AMS has required the retention of AMS's facility.
- Delay in converting from the four VAX's in Building 85 has required the retention of IBS personnel to operate AFS and the retention of the Eaton maintenance contract for the equipment.
- Delay in implementing AFS enhancements to correct known problems has required MMS to continue with existing problems and limitations.

- Limited capacity of the VAX coupled with the inordinate time associated with the processing of bills to payors has recently caused a backlog of 600 bills over 30 days old. The backlog continues to grow, causing delay in the receipt and distribution of revenues.

- Prolonged utilization of the MMS Systems Integration Project (SIP Team) personnel whose efforts could have been redirected to other programs. The approximate level of resources devoted to this team will be converted to a system improvement effort when they are freed up.

The additional costs incurred by the Government are estimated as follows:

ITEM	Daily	Through 9/30/86
SIP Team Personnel Costs	$ 2,022	$ 545,940
AMS Facility and Equipment Costs - VAX's (2)	1,810	488,700
IBS Operating Personnel Costs - VAX's (4)	3,321	896,670
Equipment Maintenance Contract - VAX's (4)	517	139,590
TOTAL	$ 7,670	$2,070,900

Management time is not included in the above totals.

Actions Taken by the Government

- Effective December 28, 1985, MMS commenced assessment of liquidated damages of $5,441.66 a day due to MMDS's failure to deliver the reimplemented AFS for Government testing. The maximum allowed under the contract ($979,499) has been assessed.

- On August 14, 1986, the MMS Contracting Officer rendered a decision denying MMDS's claim for additional compensation of $1.1 million. Our understanding is that MMDS is filing a new claim with additional information on their original claim and is planning to submit a second claim.

STATUS SUMMARY: MMDS has completed conversion of AFS application code, replacement of VAX foundation software, redesign of the data base, unit testing of programs, and integration testing of various program modules. They are currently pursuing system testing, the final MMDS step leading to certification of the system and the Government acceptance testing. MMS is confident that the AFS can be converted to the IBM mainframe with a high degree of quality, and is satisfied with quality of the intermediate products accepted to date. MMS believes MMDS needs an additional 1-3 months which, in turn, will slip AFS operation startup on the IBM.

STATUS OF THE ROYALTY AUDIT PROGRAM

BACKGROUND: Payments made to the Minerals Management Service (MMS) are accepted subject to audit. There are approximately 2,000 companies and individuals that make royalty payments on over 24,000 producing Federal and Indian leases. The 25 largest royalty payors provide approximately 80 percent of the total royalty dollars collected while the next 150 payors provide an additional 10 percent of the royalties. The remaining royalty payors provide the last 10 percent.

The MMS royalty audit program is implemented by its Royalty Compliance Division (RCD). RCD audit resources are available from both mobile and resident audit teams. The mobile teams work on any audit assignment while the resident teams are permanently located at the accounting offices of the 13 largest royalty payor companies. To assure that mineral lease revenues are properly reported and paid, RCD has been following a multifaceted audit strategy directed toward the following functional audit areas:

- Reconciliations of account balances in the former Royalty Accounting System as directed by the Federal Oil and Gas Royalty Management Act (FOGRMA).
- Resolution support and billing action for Office of Inspector General lookback audits.
- Audit referrals from BIA and BLM.
- Self-initiated company/lease/subject matter audits.
- Oversight of delegated audits to States and Tribes under FOGRMA, Sections 202 and 205.
- Review of requests for recoupment or refund of royalty payments made on Outer Continental Shelf (OCS) leases.
- Audit referrals identified as a result of the AFS and Production Accounting and Auditing System (PAAS) comparisons of sales and production data.
- Litigation support technical assistance to the Solicitor's Office.

STATUS AND DISCUSSION:

Audit Program Accomplishments total over $320 million from program inception in October 1981 through August 1986. Of this amount, $111 million has been collected so far this fiscal year. Since 1981, RCD auditors reviewed payments on 1,439 Federal onshore leases (8 percent of currently producing leases), 955 offshore leases (67 percent), and 1,283 Indian leases (27 percent).

Relatively less time has been spent by RCD on reviewing onshore leases because these leases are reviewed by State auditors under the joint audit program; relatively more time has been spent on reviewing Federal offshore leases because they produce far more revenue on average than onshore leases. Collections and refund denials are as follows:

Additional Royalties		
Federal Offshore Leases	$ 53,621,550	
Federal Onshore Leases	141,350,635	
Indian Leases	10,852,291	
Total Additional Royalties		$205,824,477
Late Payment Charges		35,530,733
Liquidated Damages		458,383
OIG Audit Collections		19,239,665 1/
Refund Denials		58,990,534
TOTAL		$320,043,792

Joint Audits are currently performed under Sections 202 and 205 of FOGRMA by the Navajo Indian Tribe and the States of Alaska, California, Colorado, Montana, North Dakota, Oklahoma, Utah and Wyoming. Through August 1986 collections included above and associated with joint audit activities totaled $45.7 million in additional royalties and late payment charges.

In the future, the RMP audit strategy will be directed toward auditing leases on a 6-year cycle in accordance with FOGRMA record retention requirements. This strategy assumes the following:

- The availability of additional resources for the overall audit program conducted by MMS, the States, and the Tribes.
- Continued participation by tribes and States in 202/205 audit activities.
- Cooperative agreements for State audits of OCS Section 8(g) leases.
- Increased activity under the BIA/MMS Indian lease audit strategy.
- Increased audits of nonstandard Indian leases (some will require a 2-year audit cycle).
- Increased audits targeted by the AFS/PAAS comparison.

1/Does not include funds paid by companies during and following the OIG's audits, but prior to the issuance of a demand notice by MMS. Through March 31, 1986, total collections resulting from the OIG lookback audits were $47.1 million.

STATUS OF INTEREST CHARGES, ASSESSMENTS, AND CIVIL PENALTIES

BACKGROUND: The Minerals Management Service (MMS) has recently implemented a comprehensive enforcement and penalty strategy to assure prompt and accurate royalty reporting and payment. The tools used to carry out this strategy include (1) interest charges, (2) erroneous, late, and nonreporting assessments, and (3) civil penalties.

Interest charges are mandated by Section 111 of FOGRMA. They are intended to compensate the U.S. Treasury and other royalty recipients for the loss of revenue resulting from late receipt of monies. Reporting assessments are a $10 charge for each line of data reported incorrectly or late, or not reported at all, on Form MMS-2014, the Monthly Report of Sales and Royalty Remittance. These assessments are authorized by Section 101 of FOGRMA, as implemented by 30 CFR 218.56.

Civil penalties are the enforcement action of last resort. They are intended for situations where a payor is unwilling to correct a violation or has repeated a violation over time and has shown no attempt at taking the necessary actions to prevent recurrence. Authorized by Section 109 of FOGRMA, civil penalties can be applied to cases where a payor:

- knowingly and willfully violates MMS reporting requirements;
- fails to provide access to required records;
- fails to comply with an MMS order; or,
- fails to pay an amount due.

STATUS AND DISCUSSION:

Interest charges. The identification of late payments and calculation of interest charges are functions performed both automatically by the Auditing and Financial System (AFS) and manually as a result of audit findings. Interest collections are shared with the States and Indians, in accordance with Sections 111(c) and (g) of FOGRMA. The States participate to the extent of their share of the royalties on which the charge is based. Indian tribes or allottees receive 100 percent of interest collections attributable to their respective leases.

The MMS has been charging interest on late payments, as part of AFS exception processing, since February 1985 and on audit findings since inception of the MMS Royalty Management Program (October 1, 1981). Interest collections for these periods have been as follows:

	Federal	Indian	Total
Exception Processing (2/85 - 8/86)	$ 9,710,000	$ 626,000	$10,336,000
Audit Findings (10/81 - 8/86)	32,960,743	2,569,990	35,530,733
	$42,670,743	$3,195,990	$45,866,733

Reporting assessments. There are currently three conditions which lead to reporting assessments: erroneous reporting, late reporting, and failure to report. These latter two conditions are frequently referred to as nonrespondent assessments.

Erroneous reporting assessments.

Identification and calculation of erroneous reporting assessments is essentially a manual process. The MMS began billing these assessments in April 1985. At that time, the criteria for assessment were a 7 percent or greater reporting error rate and a minimum of 25 erroneous lines. (An error is a condition causing a line to reject from the AFS and resulting in the system's inability to distribute the royalties reported on that line.) Beginning in July 1985, the threshold was reduced to a reporting error rate of 5 percent and a minimum of three erroneous lines. The three line minimum results from it not being cost effective for MMS to process a bill for less than $25. These assessments have served their purpose of encouraging more accurate reporting. Rejected (error) lines, as a percentage of total lines reported, have dropped from an average of 12.45 percent in FY 1985 to an average of 6.53 percent in FY 1986. As of August 31, 1986, MMS has issued 739 erroneous reporting bills totaling $417,331.

Nonrespondent assessments.

The $10 per line assessments for late reporting and for failure to report (nonrespondent) are automated processes which are considered a part of the AFS exception processing activity. These two conditions are treated similarly by the automated sytem, since whether a line is reported late or not at all, the system identifies it as not having been reported when due. These assessments differ from the late payment interest charges, as they apply to the report rather than to the payment. If a payment accompanies a report, as required by MMS regulations, and both are late, then the payor would be subject to both an interest charge and a late reporting assessment.

AFS late reporting assessments began as a manual process in March 1985. Initially, the criteria for assessment were 14 days late and a minimum of three lines. Over time, this threshold has been lowered, and since September 1985 no grace period has been allowed.

The nonrespondent assessment process (late reporting and failure to report) was automated beginning with the April 1986 report month. As of August 31, 1986, MMS has issued 1,728 nonrespondent assessment bills totaling $1,309,477 which includes the manual late reporting bills issued since March 1985.

Civil Penalties and Notices of Noncompliance. By law, civil penalties cannot be enforced until a payor has been provided an opportunity to correct the violation. The process begins with a demand letter or bill for collection. If this is not responded to, a Notice of Noncompliance is issued, explaining the violation and the remedies expected. The payor is provided 20 days from the date of service of the Notice to correct the violation. If this is not done, the civil penalty goes into effect. The payor is then expected to correct the violation and pay the penalty. The penalty continues to run, at a specified rate per day, until the underlying violation is corrected.

The first Notice of Noncompliance was issued September 29, 1984. To date, MMS has issued a Notice of Noncompliance and Civil Penalty on 16 cases. The status of these 16 cases is summarized below.

Issued	Status	Penalty Amount (Through 9/86)
9	Corrected violation before penalties accrued	-0-
2	Corrected violation and paid penalties	$8,610
3	Violation not corrected and penalty accruing (to be referred to U.S. Department of Justice)	$1,500,000
1	ALJ decision upheld MMS, company is appealing. Penalty not yet collected.	$20,440,000
1	Notice of Noncompliance and Civil Penalty mailed September 11, 1986	Pending

In addition to the 16 cases, another 8 candidates for civil penalty were contacted by telephone and encouraged to correct their respective violations before MMS mailed the written Notice of Noncompliance and Civil Penalty letter. The violations were corrected by all 8 companies before the Notice was issued.

STATUS OF MINERALS MANAGEMENT SERVICE INDIAN LEASE AUDITS

BACKGROUND: There are currently about 4,600 Indian leases for which revenues are disbursed to 21 tribes and to more than 27,000 allottees. Audits of Indian lease revenues are conducted by MMS. In FY 1986, 29 percent of the Royalty Compliance Division's personnel resources have been devoted to Indian lease revenues. [1/]

STATUS AND DISCUSSION:

MMS Indian Lease Audit Collections. Since program inception in October 1981 through August 1986, the MMS has collected $13,422,281 in additional royalties and late payment charges as a result of audit activity on Indian leases. The following two tables describe where audit activity has been focused and amounts collected by fiscal year.

MMS'S INDIAN AUDIT ACTIVITY

	Lease Audits	Reconciliations	Desk Reviews	WPT Reviews
FY 1982	10	-0-	296	-0-
FY 1983	131	1,935	112	239
FY 1984	58	364	12	47
FY 1985	391	473	-0-	128
FY 1986*	693	525	-0-	-0-
TOTAL	1,283	3,297	420	414

*Through August 1986

INDIAN LEASE AUDIT COLLECTIONS

	Additional Royalties	Late Payment Charges	Total
FY 1982	$2,115,940	$ 158,351	$ 2,274,291
FY 1983	3,675,917	807,143	4,483,060
FY 1984	1,863,586	594,837	2,458,423
FY 1985	794,738	262,502	1,057,240
FY 1986	2,402,110	747,157	3,149,267
TOTAL	$10,852,291	$2,569,990	$13,422,281

*Through August 1986

[1/] When the transcript of the FY 1987 MMS appropriations hearing was edited, the number of auditors working exclusively on Indian work was incorrectly changed from "20-some" and "28" to "8."

Joint Indian Lease Audit Strategy. In January 1986, BIA and MMS implemented a joint Indian lease audit strategy to enable the Bureaus to respond to Indian Tribal and allottee lease inquiries in a timely, effective, and efficient manner. Tribal and allottee audit requests, following review by the appropriate BIA field office, are forwarded to the MMS audit division through a central BIA office also located in Lakewood, Colorado. The BIA office in Lakewood establishes audit priorities. MMS has initiated audits of 40 Indian leases as a part of the new Indian Lease Audit Strategy.

During FY 1986, MMS also performed the following Indian lease audits in response to special requests.

- Audited 7 leases in response to Congressional requests resulting in $31,034 in additional royalty and $5,973 in late payment charge collections.
- Audited 15 leases in response to a U.S. General Accounting Office request resulting in $80,819 in additional royalty and $30,850 in late payment charge collections.
- Audited 11 leases in response to BLM requests resulting in $856,417 in additional royalty and $166,919 in late payment charge collections.

Nonstandard Lease Agreements. The MMS/BIA Joint Steering Committee recently completed reviews of selected nonstandard lease agreements issued under the Indian Mineral Development Act of 1982. Based on the review of 27 agreements, it has been determined that the agreements and their respective leases cannot be accounted for by the Auditing and Financial System (AFS). Because a number of these agreements contain limited lease record retention requirements (2-4 years), MMS has assigned audit priorities to those agreements closest to the end of their record retention period.

A total of 38 nonstandard Indian lease agreements have been identified of which 12 are currently under audit by MMS. To date, a total of $254,780 in additional revenues has been collected as a result of these audits. MMS has expended 2 staff years on nonstandard lease agreements during FY 1986 and has allocated 6 staff years to conduct audits of 5 additional agreements in FY 1987.

STATUS OF CONTRACT TO PERFORM AUDITING AND FINANCIAL SYSTEM (AFS) EXCEPTION PROCESSING

BACKGROUND: Exception processing is the identification of conditions that result in billing actions. The AFS generates billable exceptions by comparing what a payor reports and pays to what the system expects the payor to report and pay. The following exception types are identified through the process.

Royalty underpayment exceptions are created when the amount of payment received appears to be less than the royalties reported.

Late payment exceptions are generated when the payment is received after the due date.

Insufficient estimate exceptions are interest charges generated when the actual royalties paid 2 months after the sales month exceed the previously paid royalty estimates.

Nonrespondent exceptions are automatically identified and generated when a payor fails to report or reports late for a particular AID, product code, and selling arrangement.

STATUS AND DISCUSSION:

Funding and staffing levels. Funding for contract support to perform 100 percent exception processing verification was initially provided in the FY 1986 budget. The contractor began hiring personnel in January 1986, once FY 1986 funding was available. There are currently 49 contractor and 7 MMS personnel working on issuance of bills for interest, nonrespondent, and royalty underpayment exceptions as follows:

	Federal Leases	Indian Leases
o Contractor personnel	39	10
o MMS personnel	6	1

In addition, extensive MMS staff time is devoted to activities relating to post-billing functions such as industry inquiries, appeals, stays (sureties), and collections on delinquent accounts.

Findings to date. MMS issued its first AFS late payment exception processing bill in February 1985. The table below shows that as MMS gradually implemented the various other exception processing modules, numerous bills and collections of revenue have resulted.

EXCEPTION PROCESSING - BILLS AND COLLECTIONS
February 1985 through August 31, 1986
($ in thousands)

Module	No. of Bills	Net Billings	Collected Amounts	Bonded, Pending Appeal	Balance Outstanding [1]
Federal interest	2,818	$16,340	$ 9,710	$5,370	$1,260
Indian interest	1,786	$ 852	$ 626	0	$ 226
Subtotals	4,604	$17,192	$10,336	$5,370	$1,486
Federal underpayments	30	$ 78	$ 71	0	$ 7
Indian underpayments	12	$ 20	$ 19	0	$ 1
Subtotal	42	$ 93	$ 90	0	$ 8
Nonrespondent	1,734	$ 604	$ 338	0	$ 266
Totals	6,380	$17,894	$10,764	$5,370	$1,760

[1] Of the outstanding balance, $1.5 million is not yet due from the payors and the remaining $.2 million represents delinquent accounts being pursued for collection by MMS.

STATUS OF EXPLANATION OF PAYMENTS FOR INDIAN ALLOTTEES

BACKGROUND: The Department is largely in compliance with the mandated explanation of payments (EOP) requirements of the Federal Oil and Gas Royalty Management Act (FOGRMA). However, there are some improvements needed to make the reports more useful to Indians and make the reports fully compliant with FOGRMA. The MMS has provided EOP reports since October 1983 to Indian tribes and to BIA for their use in providing an EOP report to allottees. MMS consulted with Indian tribes and BIA before finalizing the format for these reports; however, as the tribes and BIA began using the reports, it became apparent that restructured and more detailed data was desired.

In addition to the EOP, an oil and gas royalty statement for Indian allottees, derived from data provided by MMS, was designed by BIA in 1985. As a result of General Accounting Office recommendations and litigation demands, BIA has recognized the need to modify the statement to accommodate additional FOGRMA requirements and to clarify information on the statement.

DISCUSSION AND STATUS: In response to the needs of Indian tribes and allottees, MMS has been working to improve the EOP. A special Form MMS-2014 and EOP were developed to identify and report royalty collections resulting from audit findings. Also, MMS has and will continue to visit with Indian tribal representatives and allottees to clarify reporting needs. In addition, MMS has developed and implemented the new State and Tribal Support System (STATSS) which allows Indian tribes and BIA full access to detailed payment information and other data elements, and which includes improved calculations of royalty rates and unit values. At the present time, nine Indian tribes and four BIA field offices are operational on STATSS.

MMS plans to implement several Indian data enhancements to the Auditing and Financial System (AFS) once the system has been converted to the new IBM mainframe computer. MMS is also undertaking a software improvements project to include modification of the EOP as requested by Indian tribes and allottees and development of special Indian reports to explain late payment interest and certain reporting or data base errors.

BIA is also working toward improvement of the oil and gas royalty statement it provides to Indian allottees. At the request of the BIA/MMS Joint Steering Committee, BIA has established a workgroup of BIA and MMS employees to improve the allottee statement. The short term goals of the group will be to improve the existing statement without a major system redesign. The statement will be reformatted to make it easier to read and understand. Also, the timeliness of the statement and payment will be improved, and the feasibility of mailing checks and statements concurrently will be studied. The workgroup will also assess the alternatives over the long term for an improved statement which may take the form of a stub attached to the allottee's check. The workgroup will provide user groups and other interested parties with proposed drafts of the revised statement throughout the redesign process to ensure that the users have input into the new design.

Both the MMS EOP and BIA's statements to allottees currently include sales volume information, but do not contain production information, one of the requirements under FOGRMA. Production information is obtained through PAAS, which is now operational for offshore mineral leases and a small number of onshore leases. The Department, with consultation from the Royalty Management Advisory Committee, is currently studying the feasibility and desirability of implementing PAAS for onshore Federal and Indian mineral leases.

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